United States Court of Appeals

for the

District of Columbia Circuit

TRANSCRIPT OF RECORD

FOR MR. JUSTICE STEPHENS

TRANSCRIPT OF RECORD

United States Court of Appeals for the District of Columbia

APRIL TERM, 1936.

No. 6764

13

MERHENGOOD CORPORATION (DEL.) PETITIONER,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

APPEAL FROM THE BOARD OF TAX APPEALS

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THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

United States Court of Appeals for the District of Columbia

APRIL TERM, 1936.

No. 6764

MERHENGOOD CORPORATION (DEL.) PETITIONER,

versus

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

ON PETITION TO REVIEW THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

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United States Court of Appeals for the District of Columbia

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1 Docket No. 59409

MERHENGOOD CORPORATION (DEL.) *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Appearances

For Taxpayer: Harold O. Walker, Esq., Paul E. Shorb, Esq.,

For Comm'r.: W. E. Davis, Esq.,

Docket Entries.

1931

Jul. 24—Petition received and filed. Taxpayer notified. (Fee paid)

" 24—Copy of petition served on General Counsel.

Sep. 18—Answer filed by General Counsel.

" 30—Copy of answer served on taxpayer. General Counsel.

1933

Feb. 7—Hearing set March 9, 1933.

Mar. 2—Motion for circuit hearing at New York Ciry filed by taxpayer. 3/7/33 granted.

Jun. 5—Notice of appearance of Paul E. Shorb as counsel filed.

" 14—Request to send all notices to Paul E. Shorb filed by Mr. Walker,

Sep. 28—Hearing set beginning 11/6/33 in New York.

Nov. 24—Hearing had before Mr. Logan Morris, Div. 14. Submitted on merits. Motion to amend petition granted. Stipulation of facts filed. Briefs due according to Board's rules.

Dec. 9—Copy of motion and amended petition served on General Counsel.

" 15—Motion for extension to 1/15/34 to file brief, filed by taxpayer. 12/15/33 granted.

1934

Jan. 15—Brief filed by taxpayer. 1/16/34 copy served.

" 29—Brief filed by General Counsel.

Feb. 7—Answer to amended petition filed by General Counsel. 2/10/34 copy served.
" 8—Reply brief filed by taxpayer. 2/8/34 copy served.
1935
Aug. 28—Memorandum opinion rendered, Mr. Logan Morris, Div. 14. Judgment will be entered under Rule 50.
Sep. 26—Notice of settlement filed by General Counsel.
" 27—Hearing set Oct. 16, 1935 on settlement.
Oct. 10—Motion to continue hearing to Nov. 20, 1935 filed by taxpayer. 10/11/35 granted.
Nov. 12—Motion to continue hearing to Jan. 15, 1936 filed by taxpayer. 11/14/35 granted.
1936
Jan. 13—Motion to continue hearing to the next New York City Circuit Calendar or continue to some date in February 1936 and that findings of fact and memorandum opinion be reopened and reconsidered. Memorandum in support thereof, filed by taxpayer.
" 14—Order of continuance to Jan. 22, 1936 for hearing under Rule 50 entered.
" 14—Hearing set Jan. 22, 1936 on motion.
" 14—Copy of notice of hearing date and motion served on General Counsel.
2 1936
Jan. 22—Hearing had before Mr. Morris on settlement under Rule 50—not contested. Motion for reconsideration and revision of memorandum opinion held C. A. V. Mr. Morris.
Feb. 5—Order that motion be denied and decision entered, Logan Morris, Div. 14.
May 1—Stipulation of venue filed.
" 2—Petition for review by U. S. Court of Appeals for D. C. with assignments of error filed by taxpayer.
" 2—Proof of service filed by taxpayer.
Jun. 4—Praecipe filed.
" 4—Proof of service of praecipe filed.

3 United States Board of Tax Appeals

Docket No. 59,409.

MERHENGOOD CORPORATION (DEL.), Room 2005, 44 Wall Street, New York, N. Y., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

U. S. Board of Tax Appeals

Filed at Hearing

Nov 24 1933

Div ..... Docket .....

Amended Petition

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency IT:AR:A-3, WMK-60D, dated June 1, 1931, and as the basis for its proceedings alleges as follows:

1. The petitioner is a corporation organized under the laws of the State of Delaware with its principal business office at Room 2005, 44 Wall Street, New York City.

2. The Notice of Deficiency (a copy of which is attached to the original Petition heretofore filed in this appeal and is there marked Exhibit "A") was mailed to the petitioner on June 1, 1931, and is incorporated herein by reference.

3. The taxes in controversy are income taxes for
4 the calendar year 1927 and the amount involved is $23,146.92.

4. The determination of tax set forth in the said Notice of Deficiency is based upon the following errors:

(a) The Commissioner erred in his computation of profit on sales of securities.

(b) The Commissioner erred in his computation of the basis for determining gain or loss on sales of securities.

(c) The Commissioner erred in his designation of the corporate name of this corporation in his Notice of Deficiency, attached to the original Petition herein and there marked Exhibit "A".

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner was organized as a corporation under the laws of the State of Delaware on December 30, 1925. In 1927 petitioner sold 3,948 shares of the common and 512 shares of the preferred stock of Blair & Co. Inc., receiving therefor $537,839.68. The cost of said shares of stock thus sold by petitioner in 1927 and basis to be used by petitioner therefor in determining gain or loss on disposition thereof was $772,719.03. Petitioner realized no taxable gain
5 on the disposition of said stock in 1927 but realized a loss of $234,879.35. The Commissioner has erroneously determined the cost or basis to be used by petitioner in determining gain or loss realized from the disposition in 1927 of said shares of common and preferred stock of Blair & Co. Inc. to have been $328,417.43.

WHEREFORE, the petitioner prays that this Board may hear the proceeding and determine:

(a) That the cost or basis to be used by petitioner in determining gain or loss from disposition of said common and preferred stock of Blair & Co. Inc. in 1927 was $772,-719.03;

(b) That the petitioner did not realize in 1927 on the disposition of said common and preferred stock of Blair & Co. Inc. a gain or profit of $209,422.25;

(c) That petitioner realized in 1927 from the disposition of said common and preferred stock of Blair & Co. Inc. a loss of $234,879.35, and

(d) Grant the petitioner such other and further relief as the nature of the case may require.

(Sgd) PAUL E. SHORB,
701 Union Trust Building,
Washington, D. C.
Attorney for Petitioner.

(Sgd) HAROLD O. WALKER
17 East 42nd Street,
New York City.
C. P. A. for Petitioner.

6 STATE OF NEW YORK,
County of New York, ss:

Henry Lockhart, Jr., being duly sworn, says that he is the President of Merhengood Corporation (Delaware); that he is duly authorized to verify the foregoing amended petition; that he has read the foregoing amended petition, or had the same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and these facts he believes to be true.

(Signed) HENRY LOCKHART, JR.

Subscribed and sworn to before me this 20th day of November, 1933.

(Signed) IDA MARY LANGE
(Seal) *Notary Public New York County*

Clerk's No. 332, Register's No. 4-L-175
Commission Expires Mar. 30, 1934.

7 *Exhibit A*

Treasury Department
Washington NP-2-26

June 1, 1931

J. Merhengood Corporation,
Room 2005—44 Wall Street,
New York, New York.

Sirs:

You are advised that the determination of your tax liability for the year 1927 discloses a deficiency of $23,146.92, as shown in the statement attached.

In accordance with Section 274 of the Revenue Act of 1926, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing

of this form will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier; WHEREAS IF THIS FORM IS NOT FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,

DAVID BURNET,
Commissioner.

by (Signed) J. C. WILMER
Deputy Commissioner.

Enclosures:
Statement
Form 882
Form 870
Exhibit A

8 *Statement*

IT:AR:A-3
WMK-60D

In re: J. Merhengood Corporation,
Room 2005-44 Wall Street,
New York, New York.

Tax Liability.

Year	Tax Liability	Tax Assessed	Deficiency
1927	$23,146.92	None	$23,146.92

Reference is made to the report of the internal revenue agent in charge, 17 Battery Place, New York, New York and to your protest dated April 30, 1931.

Careful consideration has been accorded your protest in connection with the agent's findings and the adjustments recommended by the agent have been approved by this office.

Your contention that the basis to be used in determining the profit on the sale of stock of Blair and Company should be $1,011,200.00 for 6,400 shares instead of the cost of such stock or $617,462.27, is denied.

At the time of incorporation, December 30, 1925, the capital stock was issued to Mr. Henry Lockhart, Jr., in ex-

change for an option to purchase 6,400 shares of stock of Blair and Company for $617,462.27. Immediately thereafter $617,462.27 was borrowed from Blair and Company and the option to purchase 6,400 shares of stock of Blair and Company was exercised. The stock was set up on the books at the value of $158.00 per share or $1,011,200.00. The difference between the cost, or $617,462.27 and the value set up on the books, or $1,011,200.00 was considered the value of the option assigned to the corporation.

Section 204 (a) (7) of the Revenue Act of 1926 provides as follows:

"The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

"If the property (other than stock or securities in a corporation a party to the reorganization) was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 80 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made;"

9 2

J. Merhengood Corporation Statement.
New York, New York.

Since Mr. Henry Lockhart, Jr., received all of the stock in exchange for the option, the value of the option to the corporation in accordance with the above-mentioned section, will be the same as it would be in the hands of Mr. Lockhart, Jr., the transferor.

Since the cost of the option to Mr. Lockhart, Jr., has not been established no value is allowable in arriving at the profit from the sale of the stock.

You are advised that the decision of the United States Circuit Court in the case of Harry L. Rice, et al., Trustees, against the Commissioner of Internal Revenue, referred to in your protest, has not been acquiesced in by the Bureau.

Computation

Net loss reported on return	($ 37,963.56)
Addition:	
1. Profit on sale of securities	209,422.25
Adjusted net income	$171,458.69

Explanation of change

Sale price of 3984 shares of common and 512 shares of preferred stock of Blair and Company, Incorporated	$537,839.68
Cost of stock as determined in Exhibit A below	328,417.43
Profit realized	$209,422.25
Profit reported	None
Increase in income	$209,422.25

The profit on sale of stock has been determined in accordance with articles 39 and 1561 of Regulations 69.

Computation of Tax

Net income	$171,458.69
Tax at 13½% on $171,458.69	$ 23,146.92
Tax previously assessed	None
Deficiency in tax	$ 23,146.92

10 3

J. Merhengood Corporation Statement.
New York, New York.

The deficiency in tax for the year 1928 as shown in the report will not be assessed for the reason that your return for that year was closed in accordance with the provisions of section 606 of the Revenue Act of 1928.

Due to the fact that the statute of limitations will presently bar any assessment of additional tax against you for the year 1927 the Bureau will be unable to afford you an opportunity under the provisions of Article 1211 of Regulations 69 to discuss your case before mailing formal notice of its determination as provided by Section 274 (a) of the Revenue Act of 1926. It is, therefore, necessary at this time to issue this formal notice of deficiency.

11 EXHIBIT A

J. Merhengood Corporation,
New York, New York.

Cost of Stock of Blair and Company, Incorporated.

Date Acquired	Description	Common Stock No. of Shares	Common Stock Cost	Preferred Stock No. of Shares	Preferred Stock Cost	Total Cost
December 30, 1925	Common	6,400	$617,462.27			$617,462.27
July 1, 1927	Stock Dividend	1,248	———			———
Total		7,648	$617,462.27			$617,462.27
	Stock dividend paid in preferred stock	(a)	19,998.78	512	$19,998.78	
Total		7,648 (b)	597,463.49	512	19,998.78	$617,462.27
Sold during year 1927—		3,948 (c)	308,418.65	512	19,998.78	(e) 328,417.43
December 31, 1927 Balance		3,700 (d)	289,044.84	***	****	$289,044.84

	Shares of Common	Market Value	Total
	7,648	$244.00	$18,661.12
	Shares of Preferred		
	512	122.00	624.64
	Total Market Value		$19,285.76

624.64 of $617,462.27 — $19,998.78

19,285.75

(b) 18,661.12 of $617,462.27 — $597,463.49

19,285.76

(c) 3,948 of $597,463.49 — $308,418.65

7,648

(d) 3,700 of $597,463.49 — $289,044.84

7,648

(e) Cost of Stock sold during year as shown above—$328,417.43.

12 Received Feb 7-1934 U. S. Board of Tax Appeals
Filed Feb 7-1934 United States Board of Tax Appeals

United States Board of Tax Appeals

MERHENGOOD CORPORATION (DEL.) *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 59,409.

Answer to Amended Petition

Comes now the Commissioner of Internal Revenue, by his attorney, E. Barrett Prettyman, General Counsel, Bureau of Internal Revenue, and for answer to the amended petition of the above taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1 of the amended petition.

2. Admits the allegations contained in Paragraph 2 of the amended petition.

3. Admits the allegations contained in Paragraph 3 of the amended petition.

4. (a), (b) & (c). Denies that the respondent erred as alleged in Paragraphs 4 (a), 4 (b) and 4 (c) of the amended petition.

5 (a). Denies the allegations contained in Paragraph 5 (a) of the amended petition.

Denies generally and specifically each and every allegation contained in the amended petition of the above-named taxpayer not hereinbefore expressly admitted, qualified or denied.

WHEREFORE, it is prayed that the taxpayer's appeal be denied.

(Signed) E. BARRETT PRETTYMAN
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
RALPH E. SMITH,
JOHN T. KOEHLER,
Special Attorneys,
Bureau of Internal Revenue.

13 United States Board of Tax Appeals

MERHENGOOD CORPORATION, (DEL.), *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 59409.

Paul E. Shorb, Esq., and
H. C. Walker, C. P. A., for the petitioner.
W. E. Davis, Esq., for the respondent.

14 *Memorandum Opinion.*

MORRIS: The respondent having determined a deficiency in income tax of $23,146.92 for the calendar year 1927, the petitioner brings this proceeding for the redetermination thereof, alleging error in the computation of the gain or loss upon the sale of certain securities.

The petitioner is a corporation, organized and incorporated at the instance of Henry Lockhart, Jr. under the laws of the State of Delaware on December 30, 1925, for the purpose of acquiring the 6,400 shares of common capital stock of Blair & Co., Inc., hereinafter referred to, its principal place of business being at Wall Street, New York City.

Prior to December 31, 1924, said Lockhart, having been interested in the investment banking field and having successfully organized, financed, and developed several corporations, Blair & Co., Inc., through its president, offered Lockhart an official position with the company and as an inducement he was offered the right to acquire 5,000 shares of the common capital stock of that company at its asset value on December 31, 1924, which was about $158 a share. The arrangement did not obligate Lockhart to purchase said stock but simply gave him the right to do so upon that basis.

Lockhart accepted the terms of Blair & Co., Inc., and became an officer and director thereof early in 1925. He was unable to immediately pay for said 5,000 shares of
15 stock, hence the right to acquire said stock on the basis of its book value as of December 31, 1924, was from time to time willingly extended and was finally fixed, on December 30, 1925, at 6,400 shares. The increase in the number of shares from 5,000 to 6,400 was due to stock dividends and other stock adjustments, the right on December 31, 1925 applying to 6,400 shares.

Blair & Co., Inc. paid Lockhart a salary of $25,000 per annum in the years 1925 and 1926, and $35,000 per annum in the years 1927 to 1930, both inclusive. In addition to said salaries he was paid a commission in 1928 of $16,634.82. His employment arrangement with Blair & Co., Inc. was for an indefinite duration and which he terminated on or about December 31, 1930. The arrangement under which he was employed was no part of the general corporate plan and applied to no other officers or employees of that company than himself.

The common capital stock of Blair & Co., Inc. had, on December 31, 1925, a book value of $227 a share—200 shares were sold on January 2, 1926, between a willing seller and a willing buyer, at that figure. The stock was not actively traded in but it was the custom for it to be sold and traded in at its book value.

16 On December 30, 1925, the petitioner acquired an option from Lockhart to purchase 6,400 shares of the common stock of Blair & Co., Inc. For said option it issued to Lockhart 3,000 shares of its common stock without nominal or par value. Said 3,000 shares was its only issued and outstanding stock on that date. Under the terms of the option the petitioner, on December 31, 1925, acquired said

6,400 shares of Blair & Co., Inc., stock for a cash payment of $617,462.27.

The book value of said stock on December 31, 1924, was $158.778 a share. The petitioner, in setting it up on its books used said December 31, 1924 book value of $158.778 a share instead of its book value of $227 a share on the acquisition date, to-wit, December 31, 1925.

The following memorandum statement shows the basis on which the aforementioned 6,400 shares of the stock were acquired on December 31, 1925;

Merhengood Corporation
In account with Blair & Co. Inc., 24 Broad St., New York

Date	Memorandum	Debit	Credit
1925 Dec. 31			
	Cost of 6400 Shares Blair and Company Inc. Common Stock as follows—		
17	As of Jan. 1st 1926 5000 shares at $158.788 [$158.788]	$793,890.00	
	Equivalent of 6% on Premium of $29,389.00		
	From Jan. 1 1925 to Sept. 1, 1925	11,755.60	
	As of Sept. 1, 1925 Equivalent of 500 Shares–New–at par	50,000.00	
	As of Sept. 1, 1925 1,000 Shares being Equivalent of 20% stock dividend		
		$855,645.60	

Less Equivalent at 111.801 per Share of 40% of Stock Dividend in Preferred on Common	223,602.00		
	$632,043.60		
Less Proceeds 100 shares Surrendered			
$14,585.33			
Less Tax 4.00			
	14,581.33		
BALANCE DUE		$617,462.27	
Proceeds from Blair and Company note of Merhengood Corporation			$617,462.27
		$617,462.27	$61,462.27

E AND O E

NEW YORK—DECEMBER 31st 1925.

The item of $223,602, appearing as a credit in the above statement in reduction of the acquisition price of said 6,400 shares of common capital stock of Blair & Co., Inc., represents the value of a dividend paid in preferred stock
18 during the year 1925 by Blair & Co., Inc. on its common capital stock. The petitioner owned none of the common capital stock of Blair & Co., Inc. until December 31, 1925. The item of $223,602 represents a credit made of that sum by Blair & Co., Inc. in favor of Lockhart, the owner of the aforementioned right, and said sum was used in reduction of petitioner's purchase price of said stock as shown above.

The item of $14,581.33 appearing as a credit on the aforementioned statement of account represents the amount realized during 1925 by Lockhart, by disposition of his right to acquire 100 shares of the common stock of Blair & Co., Inc. Said sum was applied by Blair & Co., Inc. in reduction of the price to be paid by petitioner for the acquisition of the aforementioned common stock of Blair & Co., Inc.

It became necessary to borrow the money with which to make the purchase and Blair & Co., Inc., a banking partnership, which made the loan of $617,462.27 to the petitioner on December 31, 1925, and took its note for said amount with the said 6,400 shares of common stock of Blair & Co., Inc. as collateral security therefor, was desirous of having the petitioner corporation organize so that liability of Lockhart for the purchase price of said shares would be kept separate and distinct from his other assets and
19 liabilities.

Blair & Co., Inc., in its 1925 Federal income tax return, showed a loss in its surplus account from the disposition of said 6,400 shares of its common stock to the petitioner.

The basis used by the respondent in determining the profit of $209,422.25 realized by the petitioner in 1927 from the disposition of 3,948 shares of common and 512 shares of preferred stock of Blair & Co., Inc. begins with a cost to the petitioner of the 6,400 shares, $617,462.27, and includes no other sums therein.

In addition to the foregoing the parties have stipulated the following:

(14) If petitioner's cost is $1,452,800.00, representing a cost basis for said 6,400 shares of common capital stock of $227.00 per share, or on the basis of $1,011,200.00, representing a cost basis of $158.788 [$158.778] per share, petitioner realized no gain in 1927 on the disposition of said 3,948 shares of common and 512 shares of preferred stock of Blair & Co., Inc. and no part of the deficiency asserted by the respondent in his 60-day deficiency notice of June 1, 1931, is due or owing from the petitioner.

(15) If the Board holds that petitioner's cost of $617,462.27 for said 6,400 shares of common capital stock of Blair & Co., Inc. on December 30, 1925, is to be increased by

(a) $223,602.00, and

(b) $14,581.33,

or either of said sums, the parties agree that proper
20 adjustment is to be made in the cost of said stock and the requisite corresponding adjustment is to be made on the profit, if any, realized by petitioner in 1927 on the disposition of 3,948 shares of common and 512 shares of preferred stock of Blair & Co. Inc.—the method of said ad-

justment to be as heretofore determined by respondent in his 60-day deficiency notice of June 1, 1931, to petitioner with necessary adjustment made in the cost to be allocated respectively to the common and preferred stock of Blair & Co. Inc. on account of such increase as may be determined by the Board in the cost to petitioner on December 31, 1925, of said 6,400 shares of common capital stock of Blair & Co. Inc.

(16) If the Board should hold that the right given to Henry Lockhart, Jr. to acquire the common capital stock of Blair & Co. Inc. as previously related herein represented at that time taxable income to him, the fair market value of said right to acquire said stock on December 30, 1925, was $835,337.73.

(17) Henry Lockhart, Jr. did not include in his taxable net income for 1925 as reported on his individual tax return for said year said sum of $835,337.73 or any part thereof, nor did he pay any individual income tax for 1925 on account thereof. Henry Lockhart, Jr. did not include in his taxable net income for 1925, as reported for his individual tax return for said year the sum of $223,602.00 referred to in paragraph (10) hereof or the sum of $14,581.33 referred to in paragraph (11) hereof, nor did he pay any individual income tax for 1925, on account of said items or either of them.

To summarize, Lockhart, a successful business man, at some time prior to December 31, 1924, was offered and he accepted an official position with Blair & Co., Inc., at a fixed annual salary. As an added inducement he was given the right to acquire shares of the common capital stock of
21 that company at its asset value on December 31, 1924, which was about $158 a share. Being unable to immediately pay for the shares offered, such offer was extended until the transaction was finally fixed on December 30, 1925 at 6,400 shares. The common stock of the company had a book value of $227 on December 31, 1925. Lockhart did not exercise his option but did, at the behest of the company, organize this petitioner and on December 30, 1925, he transferred his option to purchase said stock to the petitioner in exchange for its entire issued and outstanding stock on that date. The petitioner, on December 31, 1925, acquired the said 6,400 shares of capital stock paying $617,-

462.27 therefor. The respondent determined a profit of $209,422.25 as having been realized by the petitioner in 1927 from the disposition by the petitioner of 3,948 shares of the common and 512 shares of the preferred stock of Blair & Co., Inc., and in so doing began with the cost to it for said 6,400 shares of $617,462.27.

The petitioner contends that the agreement between Blair & Co., Inc. and Lockhart was an employment contract and that Lockhart realized income thereunder; that such income was the difference between the fair market value of the Blair & Co., Inc. stock, covered by the option, and the price to be paid under such option, and finally that the cost
22 of the Blair & Co., Inc., stock to this petitioner was the cash paid by it therefor plus the cost of the option to Lockhart. The respondent contends, on the other hand, that when Lockhart's option to acquire shares of Blair & Co., Inc., at the book value thereof, which he later assigned to this petitioner in exchange for all of its capital stock, was exercised by this petitioner and the stock of Blair & Co., Inc. received thereunder was sold, the basis for the determination of gain or loss upon the sale was the amount expended by the petitioner in the exercise of its rights.

The following sections of the Revenue Act of 1926 control our determination:

Sec. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

* * * * * *

(b) (4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

Sec. 204. (a) The basis for determining the gain or
23 loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * * *

(8) If the property (other than stock or securities in a corporation a party to a reorganization) was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of section 203 (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made; * * *

The petitioner strongly relies upon *Albert Russel Erskine,* 26 B. T. A. 147. There the petitioner entered into an agreement in 1922 to work for the Studebaker Corporation. His contract provided that he should receive a fixed annual salary and that he should have the right to purchase and receive a certain number of preferred and common shares of that corporation, determinable upon the basis of the annual profits, upon payment to that corporation of a nominal price a share. The corporation purchased the shares covered by the petitioner's option at a cost to it several times the option price to the petitioner, and it placed such shares in escrow subject to the terms of the agreement.

The petitioner there, did not, as Lockhart did, assign
24 his option to a corporation to be exercised by it. He exercised his option and received the shares thereunder according to the terms of the agreement entered into. The principal question there presented was whether or not the excess in the market value of the right to buy the shares of stock of Studebaker Corporation over the price to be paid therefor by Erskine was taxable to the petitioner as compensation for services performed as and when he exercised his option. In disposing of this we held that the agreement between the Studebaker Corporation and Erskine was essentially an employment contract and that any amounts realized therefrom constituted compensation for his services, and furthermore, that the amount of such compensation taxable in each year on account of the receipt of the rights to buy shares of stock was the difference between their market value on the date received and the price which the petitioner was compelled to pay under his option.

The Erskine case is helpful in the instant proceeding as far as it goes but it does not go far enough to control or to solve our problem.

As a matter of fact it may be doubted that whatever benefit Lockhart would have enjoyed had he exercised his option was compensation for services rendered under the reasoning of the Erskine case, for the reason that Erskine's benefit was purely prospective and entirely dependent upon the earnings of the corporation, whereas here, for all that we know, Lockhart may well have exercised his op-
25 tion at the very outset of his employment with Blair & Co., Inc. See *Bothwell* v. *Commissioner,* 77 Fed.
(2) 35.

Even conceding that Lockhart's unrealized benefit should be classified as compensation for services rendered, and that the Erskine case is similar to that extent, for the same result must be reached in any event, we disagree with the petitioner's argument that Lockhart realized taxable income under his option. An option, as such, is merely an offer looking forward to acceptance, which is the exercise thereof, and until it is exercised or revoked it remains such. There was no compulsion whatsoever upon Lockhart to exercise his option. Indeed, if the market for Blair & Co., Inc. stock had declined rather than advanced the likelihood of his exercising it would have been very remote. Under the circumstances it requires little reflection to understand why an effort on the part of the taxing authorities to levy an income tax against Lockhart would have met with prompt disapproval by this Board and by the courts.

Both parties seem in agreement that the transaction by which Lockhart assigned his option to this petitioner for its capital stock was a nontaxable exchange under section 203 (b) (4), *supra.*

The normal basis for the determination of gain or loss under section 204, *supra,* is the "cost" of property. The exception under subdivision (8) of that section,
26 where the property falls within section 203 (b) (4), *supra,* that is, where the property was transferred to a corporation in a nontaxable exchange, is that "the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such

transfer under the law applicable to the year in which the transfer was made."

Lockhart received the right to purchase the stock of Blair & Co., Inc. at $158 a share. If Lockhart had exercised his original right and had received his stock, thus actually determining his immediate benefit thereunder, adopting the same reasoning of the Erskine case, he would have been taxable upon the difference between $158 and the fair market value of the stock at the time he might have exercised his option. If he had disposed of his stock his new basis for the determination of his gain or loss upon such sale would have been the fair market value of the stock at the time of exercise. However, he did not exercise his option, thus he committed no act upon which a tax might be predicated, but instead he chose to transfer his option to the petitioner in a nontaxable exchange under the statute, hence no new basis was established by him either during the ownership of the option by him or because of his transfer thereof to the corporation. Under the statute the petitioner is compelled to adopt whatever basis Lockhart would have had had his gain or loss for tax purposes have been the subject of consideration.

We must inquire what Lockhart's basis would have
27 been under the circumstances. Obviously, he would not have been entitled to adopt the value of $227 a share, or a total of $1,452,800, for the reasons just stated. Nor indeed, would he have been permitted to adopt the value of $158 a share since further adjustments were made to the original option price between the date of granting and its ultimate exercise reducing the cost of the 6,400 shares to $617,462.27, or $96,48 a share. The agreement between this petitioner and Lockhart by which it acquired its rights under Lockhart's option is not before us and, of course, we must proceed on the most logical assumption that the option as exercised by the petitioner was in all respects as it would have been exercised by Lockhart himself. In other words, we must assume that the petitioner's rights under the option were the same as Lockhart's and that if Lockhart himself had first exercised the option and turned the stock over to this petitioner he would have paid not $158 a share but the equivalent of $96,48, or $617,462.27, the amount actually paid by this petitioner. The adoption of this basis

eliminates all theories and taxes the actual benefit derived under the option by Lockhart and his assignee, this petitioner. This is the basis adopted by the respondent and, accordingly, his determination is approved.

We find ourselves unable to comply with the stipulation of the parties that the items of $223,602 and $14,581.33 should be included in the "cost" to Lockhart, if the
28 parties used the word "cost" as the equivalent of basis since it is in conflict with paragraph (15) of the stipulation, the effect thereof is largely a conclusion of law, depriving the Board of its prerogative to determine for itself, upon the facts, whether such items are properly includable in the basis under the statute, and, furthermore, it appears from a consideration of the actual facts as stipulated that to include such items in the basis we have established, would result in an erroneous determination. *Ohio Clover Leaf Dairy Co.,* 8 B. T. A. 1249, affirmed 34 Fed. (2) 1022, certiorari denied 280 U. S. 588; *Lewis* v. *Commissioner,* 47 Fed. (2) 32; *William Ernest Seatree,* 25 B. T. A. 396, affirmed 72 Fed. (2) 67. The $223,602 item is simply a credit that was allowed by Blair & Co., Inc. in Lockhart's favor which was used in the reduction of this petitioner's purchase price of the stock, and the $14,581.33 item is an amount realized by Lockhart in 1925 by the disposition, in what manner we are not told, of 100 shares of the common stock of Blair & Co., Inc. which was applied by that company in the reduction of the purchase price to be paid by the petitioner. Thus both items have been given full effect to in arriving at the base which we have found and which the respondent has used in his determination. There seems to be no justification whatsoever for increasing that base by those amounts which will clearly distort the true profit derived from the transaction.

Judgment will be entered under Rule 50.

ENTER:
ENTERED
Aug 28 1935

29 Endorsed: United States Board of Tax Appeals

Filed Jan 13 1936

United States Board of Tax Appeals

Docket No. 59409

MERHENGOOD CORPORATION, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Motion in this Appeal that the Rule 50 Hearing be Continued; That Findings of Fact and Memorandum Opinion in this case be Reopened, Reconsidered and Revised; That the Principle of Tillotson Manufacturing Company v. Commissioner, *infra,* be Applied; and Further Hearing Granted Herein.

Now comes the petitioner by its attorney, Paul E. Shorb, and moves this Honorable Board as follows:

(1) That the Board delay entry of "decision" in this case pending consideration and action upon this motion and supporting memorandum. Hearing for settlement of the deficiency under Rule 50 is now set for Wednesday, January 15, 1936, which hearing it is hereby moved be continued and until after the Board has considered and acted upon this motion and supporting memorandum.

(2) That the Board reconsider, amend and revise its memorandum opinion in this case to give effect to the Stipulation of Facts between the parties and to have its
30 opinion accord with its decision in the appeal of *Rossheim,* 31 B. T. A. 857, and like decisions as referred to in the supporting memorandum filed herewith (see pages 2 to 18 thereof).

(3) That revision be made in the Board's Memorandum Opinion promulgated August 28, 1935, for the reasons set out in the accompanying memorandum. The Board is particularly requested to give effect to the Stipulation of Facts between the parties heretofore submitted in this appeal. In this connection reference is made to the facts stipulated in paragraphs (10) and (11) of the Stipulation of Facts. The Board has disregarded the Stipulation of the parties. Said Stipulation was entered into by petitioner in this proceed-

ing in the belief that the facts as agreed to by the parties would be adopted by the Board. The recent decision of the Supreme Court of the United States in *General Utilities & Operating Co.* v. *Commissioner,* 80 Law. Ed. 174, decided December 9, 1935, (reported in 1935 C.C.H. Federal Tax Service, Paragraph 9658), states, with reference to the effect of stipulation of facts submitted to the Board (pages 176, 177):

"Always a taxpayer is entitled to know with fair certainty the basis of the claim against him. Stipulations concerning facts and any other evidence properly are accommodated to issues adequately raised.

* * * * * *

"Here the court undertook to decide a question not properly raised. Also it made an inference of fact directly in conflict with the stipulation of the parties and the
31 findings of the Board, for which the record affords no support whatever. To remand the cause for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause."

The parties in this proceeding *stipulated* as follows:

"Said sum of $223,602.00 represents an amount to be included in the cost of Henry Lockhart, Jr.—the transferor to petitioner—of the aforementioned option or right."
(See last sentence, paragraph (10) of Stipulation of Facts.)

"Said sum of $14,581.33 was applied by Blair & Co. Inc. in reduction of the price to be paid by petitioner for the acquisition of the aforementioned common capital stock of Blair & Co. Inc. and is to be included in the cost to Henry Lockhart, Jr. of said option or right to acquire common capital stock of Blair & Co. Inc."
(See last sentence, paragraph (11) of Stipulation of Facts.)

The Board in its opinion does not give effect to this Stipulation of the parties. Clearly the amount of the *cost* to Henry Lockhart, Jr. of his right to acquire stock in Blair & Co. Inc. is a fact question. The parties obviously so regarded it. Authorities on this are cited on pages 18 to 24 of the supporting memorandum submitted herewith.

(4) That the Board reconsider its Memorandum Opinion and apply the rule of *Commissioner* v. *Tillotson Manufacturing Co.* 76 F. (2d) 189, in this appeal. The Stipulation of Facts heretofore submitted in this appeal, paragraphs

(9), (10) and (14), shows that Blair & Co. Inc. paid
32 during 1925 a 40% "stock dividend in preferred on common". The statement of December 31, 1935, set out in paragraph (9) of said Stipulation of Facts shows the treatment of said preferred stock dividend paid on the common stock of Blair & Co. Inc. and shows a *credit* of $223,-602.00 on account thereof which, as stated in paragraph (10) of the Stipulation of Facts "represents a credit made of that sum by Blair & Co. Inc. in favor of Henry Lockhart, Jr., the owner of the aforementioned right to acquire the common stock of Blair & Co. Inc. and said sum was used in reduction of petitioner's purchase price of said common capital stock as shown by the statement in paragraph (9) hereof". (See paragraph (10) of Stipulation.)

The case of *Commissioner* v. *Tillotson Manufacturing Company,* 76 F. (2d) 189, affirming 27 B. T. A. 913, establishes that said 40% preferred stock dividend paid on the common stock of Blair & Co. Inc. during 1925 is not a *stock* dividend for tax purposes. This principle was followed by the Board in the appeals of *James H. Torrens,* 31 B. T. A. 787 and *H. C. Gowran, et al.,* 30 B. T. A. 820. The Board is requested to apply said principle to said 40% dividend paid by Blair & Co. Inc. in September, 1925, in preferred stock on its common stock. Clearly said $223,602.00 item, as referred to in paragraphs (9) and (10) of the Stipulation of Facts herein represented under the facts before the Board in this proceeding taxable income in 1925 to Henry Lockhart, Jr. and said item properly, and under the law,
then became part of Lockhart's *cost* of the right to
33 acquire stock in Blair & Co., as referred to in the Stipulation of Facts in this appeal.

If further facts with respect to said 40% dividend in preferred stock paid in September, 1925, on the common stock of Blair & Co. Inc. are desired for application of the principle of the *Tillotson Manufacturing Co.* case, the petitioner hereby requests that this proceeding be set down for further hearing and specially assigned to the next Circuit Calendar of the Board, New York City, which will presently commence, or for a hearing on the Board's Day Calendar here

in Washington, some day in February, 1936, as the Board may decide.

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34 United States Board of Tax Appeals

Docket No. 59409

MERHENGOOD CORPORATION, (Del.), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Memorandum in Support of Petitioner's Motion for Reconsideration and Rehearing.

It is respectfully submitted that the Board's opinion entered in this proceeding on August 28, 1935, should be reconsidered or a rehearing granted because the opinion is: (a) Not based upon and is contrary to the evidence and, (b) Is in conflict with and contrary to the law as enunciated in other Board and Court decisions.

The Board's memorandum opinion holds: (1) that it is doubtful whether the rights Lockhart received under the option constituted compensation for services; (2) that even if these rights were compensation for services, Lockhart realized no taxable income therefrom and, (3) that the amounts which the parties stipulated should be included as part of Lockhart's cost, should be disregarded.

35

I.

The Board's Opinion that the Benefits and Rights under the Original and Amended Options did not Constitute Compensation for Services is Contrary to the Record Facts and Pertinent Decisions.

The Board's opinion after commenting that the *Erskine* case, 26 B. T. A. 147, is helpful in the instant proceeding as far as it goes, but that it does not go far enough to control or solve our problem, states (page 12):

"As a matter of fact it may be doubtful that whatever benefit Lockhart would have enjoyed had he exercised his option was compensation for services rendered under the reasoning of the Erskine case, for the reason that Erskine's benefit was purely prospective and entirely dependent upon the earnings of the corporation, whereas here, for all that we know, Lockhart may well have exercised his option at the very outset of his employment with Blair & Co., Inc."

The inference that Lockhart actually exercised his option "at the very outset of his employment with Blair and Co., Inc." and therefore the benefits derived under the option was not compensation for services is clearly unwarranted by the record before the Board.

Paragraph (3) of the Stipulation of Facts definitely states that the "right to acquire said common capital stock of Blair & Co., Inc. * * * was from time to time extended and was finally fixed on December 30, 1925" and "Blair & Co., Inc. was willing to give Lockhart this extension of time for exercise of the right because he was in its employment."

Paragraph (8) of the Stipulation of Facts states that
36 "Petitioner on December 30, 1925, acquired * * * an option to purchase" and petitioner issued 3,000 shares of its stock "for said option" and "Under the terms of said option petitioner on December 31, 1925 acquired" said stock of Blair & Co., Inc. If Lockhart actually exercised the option at the very outset of his employment, there would certainly have been no necessity for extending the right to exercise the option. The option would, in fact, have disappeared and a binding contract have taken its place. There would have been no *option* which petitioner could have acquired. The Board's opinion is therefore clearly in error in inferring that Lockhart exercised his option at

the very outset of his employment and that therefore the rights under the option were not compensation for services.

The fact that Lockhart could have, but did not, exercise his original option early in 1925 when he joined Blair & Co., Inc. does not in any way justify the conclusion that the original option and the amended options were not in fact compensation for services. The original option which permitted Lockhart to buy 5,000 shares of stock early in 1925 at its book value as of December 31, 1924, clearly had a value. Blair & Co., Inc. was a closely held company, and it is obvious that its stock was not available to everyone, as was the Studebaker Company stock in the *Erskine* case. The option therefore early in 1925, when it could first have been exercised by Lockhart, had a definite value. The sub-
37 sequent amendments to the option during 1925 whereby Lockhart on December 30, 1925, was permitted to buy 6,400 shares of Blair & Co., Inc. stock for $617,462.27 certainly were valuable as is evidenced by the fact that said 6,400 shares were actually worth $1,452,800.00 on December 30, 1925. See Par. (6) of Stipulation.

The original option and the amended options having substantial value, the question arises whether these valuable rights were compensation for services or something else. The Board's opinion doubts that the rights under the options were compensation for services, but does not indicate why Blair & Co., Inc. actually divested itself of these valuable rights. Petitioner submits that the Board has clearly ignored the evidence in doubting that the rights under the option were compensation for services. Any doubt on this was removed by the statement on page 13 of respondent's brief where he *admits* that the agreement was an "employment contract."

Further, the Stipulation (Par. 2) shows that the original option was granted Lockhart "as an inducement to the latter's becoming an officer and director in Blair & Co., Inc., and entering its employ, * * *". The valuable amended options were given to Lockhart by Blair & Co., Inc. "because he was in its employment." (Par. 3 of Stipulation) These facts clearly establish that the valuable rights arising under the original option and the amended options were given to Lockhart by Blair & Co., Inc. because he accepted the terms of their employment and because of his employment and services rendered the company during

1925. Clearer words to establish these facts could
38 not have been chosen, than those used in the Stipulation.

The Board's opinion attempts to distinguish the *Erskine* case on the theory that Erskine's benefit was purely prospective and entirely dependent on the earnings of the corporation. This distinction is not, however, well taken.

An analysis of the *Erskine* case clearly shows that it was not the fact that Erskine's benefit was uncertain or prospective that induced the Board to conclude that the benefit was compensation for services. The fact that the benefit was prospective and could not be determined until the end of the year was the reason given by the Board for holding, *not* that Erskine received compensation for services, but that Erskine received no benefit at the time of the acquisition of the contracts. The Board had already determined in the earlier paragraphs of its opinion that the contract between Erskine and the corporation was an employment contract. Simply from a logical standpoint, certainty or uncertainty of payment should not be controlling or even compelling factors in determining if payment is compensation. As a matter of fact, certainty of payment is more often identified with employment contracts than speculative payments.

Furthermore, the Board has definitely held that the benefits under an option need not be purely prospective and entirely dependent on earnings of a corporation be-
39 fore they constitute compensation for services. See the case of *Irving D. Rossheim,* 31 B.T.A. 857, where the petitioner was already in the employ of the Stanley Company and was given an option to purchase 10,000 shares of stock of the company at $40.00 per share when it was selling on the stock exchange at $55.00 per share. This right was not purely prospective or dependent on earnings of the corporation. No mention was made in the contract between the parties that the option was given for services but the Board, nevertheless, found that petitioner's services were in fact the consideration for the valuable option.

Finally, if the benefits which accrued to the petitioner under the original option and the amended options were not compensation for services, what were they?

The evidence shows that the option to purchase was not a purchase by an officer under a corporation sale plan.

See paragraph (5) of the Stipulation. How identically this parallels the situation in the *Erskine* case is shown by the excerpt from the Board's opinion in that case (page 161):

"The agreement under which the petitioner received his rights was no part of a general corporate plan. It included no other officer or employee."

Likewise under the test laid down by the Board in the *Erskine* case, the agreement between Lockhart and Blair & Co., Inc. was not a sale (page 161):

"He assumed no risk in the possible event of a subse-
40 quent decline in the market value of the shares below the price named in the agreement because he was under no obligation to purchase them."

and for this reason the Board went on to conclude:

"* * * We cannot regard the substance of the transaction here merely as a purchase and sale."

The evidence in the instant case shows that "The arrangement did not obligate Henry Lockhart, Jr. to purchase said stock but gave him only the right to do so on said basis." (Stipulation Par. (2)) Thus, under the above stated rule in the *Erskine* case, the transaction with Blair & Co., Inc. cannot be regarded as a purchase and sale.

Since the arrangement between the parties could not be a sale, the only other question which could arise is "Was the transaction a gift?" In answering this question, we may again turn to the *Erskine* case where the Board said (page 157):

"The officers and directors of the corporation had no lawful right to make a gift to the petitioner of any part of the value of the shares of stock, or to 'sell' them at a price known to be considerably less than their cost or market value. We must assume that the officers and directors did not act unlawfully. Noel v. Parrott, 15 F. (2d) 669."

Likewise in the *Rossheim* case, *supra*, when confronted with a factual situation like that of the present case and the *Erskine* case, the Board at page 867 referred to *Noel v. Parrott, supra*, and reiterated its former statement:

"So we must assume here that the officers and directors did not act unlawfully."

If the Board could not assume that the officers
41 and directors acted unlawfully in the *Rossheim* and *Erskine* cases, there is no reason why it should

assume that the officers and directors of Blair & Co., Inc. did act unlawfully and made a gift or gifts in the present case.

Since the valuable options in the case of this petitioner were not sales or gifts, the only alternative is that they were compensation for services in connection with a contract of employment. Such conclusion is squarely in accord with the facts and the logic of other pertinent cases. As stated heretofore, the record definitely shows (Stip. Pars. (2) and (3)) that the valuable original option was granted Lockhart "as an inducement to the latter's becoming an officer and director in Blair & Co., Inc., and entering its employ" and that the increasingly valuable amended options were given to Lockhart by Blair & Co., Inc., "because he was in its employment." These are the facts and they may not be ignored by the Board.

The fact that the agreement in this case did not take the form of a written formal contract does not *preclude* it from being a contract of employment as is well stated by the Board in *Rossheim v. Commissioner, supra,* page 867.

The fact that Lockhart received a salary as well as the option does not prevent the latter from being compensation for services. As stated by the Board in the *Erskine* case (page 155): "The contract does not expressly limit petitioner's total compensation to $100,000 per year. It
42 merely provides for a fixed yearly salary of that amount."

Lockhart's promise to service and the services subsequently rendered Blair & Co., Inc. are the only consideration which Blair & Co., Inc. received for the valuable options. The record clearly shows this to be the case. The identical consideration existed in the *Erskine* and *Rossheim* cases, the Board stating in the latter case (page 867): "Here the consideration moving from petitioner to the corporation was services." Services being the valid consideration for the valuable options, how can it be doubted but that the benefits arising under the options were actually compensation for services.

No conclusion to the whole matter could be more pertinent, nor any statement more exactly appropriate to the facts of the case now before the Board than the following passages from the Board's opinion in the *Rossheim* decision and *Erskine* decision:

"Taxation is a practical matter and we must look to the substance rather than the form. Business men acting as directors and officers do not ordinarily give away the funds in corporate treasuries without adequate consideration. We are well satisfied that the petitioner would not have been given the option in question if he were not president of the corporation, under all the facts and circumstances as shown by the proof." (p. 867, *Rossheim v. Commissioner, supra*)

"The agreement itself, which appears in full above, bears all of the essential characteristics of an ordinary employment contract. The petitioner was to serve as president of the corporation, or in some position of equal
43 dignity, for a period of between four and five years beginning January 1, 1922, and was to receive a fixed annual salary of $100,000 and further consideration in the form of rights to acquire certain shares of the stock of the corporation at an advantageous price. * * *" (p. 161, *Erskine v. Commissioner, supra*)

It is respectfully submitted that the Board should accordingly reconsider its opinion and in accordance with the evidence before it and on the basis of pertinent cases, hold that there can be no doubt but that the rights and benefits which accrued to Lockhart in 1925 under the original and the amended options were compensation for services.

II

Lockhart Realized Taxable Income During 1925 when He had the Right to Exercise the Original and Amended Options.

On page 13 of the memorandum opinion handed down in this case, the Board makes this statement:

"Even conceding that Lockhart's benefit should be classified as compensation for services rendered, and that the *Erskine* case is similar to that extent, for the same result must be reached in any event, we disagree with petitioner's argument that Lockhart realized taxable income under his option."

The Board opinion attempts to justify this conclusion by reasoning that an option is merely an offer looking forward to acceptance, which is the exercise thereof and until it is exercised or revoked, it remains such. It is also stated that there was no compulsion whatever upon Lockhart to

exercise the option and therefore the Board and the Courts would have disapproved any effort to tax him upon
44 the income resulting from his right to exercise the options.

This conclusion is fundamentally unsound and erroneous. While it should not be necessary to discuss the nature of an option in this memorandum, it is clear that the efforts in the Board's opinion to classify the options as mere offers is quite beside the point. Likewise the fact that Lockhart could refrain from exercising the option has absolutely no bearing on the case. The only important question is, did Lockhart receive an enforcible valuable right against Blair & Co., Inc. during 1925 when he received the original and amended options. It is clear he had given the company the necessary consideration, namely, entering its employ and continuing in its employment. This being true, Williston at Sec. 61, p. 106, in his treatise on contracts states the law as follows:

"So if consideration is paid for an offer though no seal is attached, the offer is a contract. Such contracts are generally called options."

Likewise in the *Rosshcim* case, supra, the Board at page 867 specifically pointed out that option contracts must be supported by consideration.

The controlling factor is not that Lockhart was not required to exercise his option, but that Blair & Co., Inc. had given him more than an offer lookig forward to acceptance . . . they had given him an irrevocable offer. Their original offer became irrevocable when he came with the company early in 1925. By reason of his continued
45 employment and services to the company he was given irrevocable amended options until on December 30, 1925 he was given an irrevocable option to acquire on that date 6,400 shares of stock at a figure $835,337.73 below the market price. The fact that he could refuse to exercise the option is quite immaterial.

The Board's memorandum opinion then attempts to justify the conclusion that Lockhart realized no taxable income under the options by stating (page 14):

"However, he did not exercise his option, thus he committed no act upon which a tax might be predicated, but instead he chose to transfer his option to the petitioner in a nontaxable exchange under the statute, hence no new basis

was established by him either during the ownership of the option by him or because of his transfer thereof to the corporation."

The Board's opinion thus erroneously assumes that because the option was transferred to petitioner, Lockhart escaped the taxable income which would have resulted to him, had he made no transfer and personally exercised the option. The Board's opinion admits that if Lockhart had personally exercised the option, he would have realized income and the basis on subsequent disposition of stock would have been the fair market value of the stock at the time the option was exercised. This is unequivocally stated on page 14 of the opinion as follows:

"If Lockhart had exercised his original right and
46 received his stock, thus actually determining his immediate benefit thereunder, adopting the same reasoning of the *Erskine* case, he would have been taxable upon the difference between $158 and the fair market value of the stock at the time he might have exercised his option. If he had disposed of his stock his new basis for the determination of his gain or loss upon such sale would have been the fair market value of the stock at the time of the exercise."

In other words, the Board's opinion would lead one to believe that Lockhart could escape taxation on the income resulting from the right to exercise the option by merely transferring it to petitioner in a non-taxable exchange and then permitting petitioner to exercise the option. This strange result is squarely contrary to decision in the *Erskine* case. There Erskine assigned the right to acquire certain shares of stock to his wife, but the Board properly held that this did not relieve Erskine from tax liability thereon.

The Board's statement in the memorandum opinion (pages 11 & 12) referring to the *Erskine* case that, "The petitioner there, did not, as Lockhart did, assign his option to a corporation to be exercised by it. He exercised his option and received the shares thereunder according to the terms of the agreement entered into" is squarely contrary to the facts since it is clearly shown that for certain years Erskine's wife was assigned the option and actually exercised it. For example, on page 158 of 26 B. T. A. in the Board's Findings of Fact in the *Erskine* case, it is stated:

"On November 1, 1923, the petitioner made a similar assignment to his wife of his rights to acquire the preferred stock only, based on the corporation's earnings for 1923, which she exercised in February 1924, paying to Goldman, Sachs & Company $62,500. and receiving 2500 shares of the preferred stock."

47

In spite of this assignment, the Board properly held (p. 164):

If we are correct in our conclusion that the value of the rights measured by the excess value of the shares of stock acquired by the petitioner or his assignee in each year under the agreement represented compensation for services, then, under the rule of the *Earl* case, (Lucas v. Earl, 281 U. S. 111), we think that such compensation must be taxed to the petitioner as his own income, regardless of the assignments to his wife."

Erskine, in the aforementioned instances, "committed no act upon which a tax might be predicated" other than assigning the option to his wife. Nevertheless, the Board correctly taxed the income to him. The act of exercising the right is apparently quite immaterial and if it were material, it is clear that the exercise by the transferee in a non-taxable transfer, would be sufficient to constitute an exercise of the right by the transferors.

The fact that in the *Erskine* case the rights were transferred to petitioner's wife in a non-taxable transaction whereas here the rights were transferred to a wholly owned company does not alter the situation. For example, in the case of A. D. Saenger, 28 B.T.A. 377, the petitioner owned 50% of the stock in a corporation and transferred certain property which he was entitled to receive as compensation for services, to the corporation. The Board, nevertheless, held the value of the property was income to the petitioner. The Appellate Court (C.C.A. 5th) affirmed the Board in its opinion reported in 69 Fed. (2d) 631.

48

The mere failure of Lockhart to exercise the option in person does not prevent the valuable rights given by the original option and the amended options from being taxable to him. As pointed out heretofore, if "exercise of the right" is a prerequisite, the exercise by the petitioner of the right is sufficient to result in taxable income to Lockhart.

But petitioner does not admit that it was necessary to exercise the options in order to have income result to Lockhart. The mere right to purchase stock, which right had a value in excess of $800,000 and which was given to Lockhart as compensation for services in the year 1925 can not be arbitrarily eliminated from his income by a mere failure to exercise it. It is established law that the mere failure of a bondholder to clip his coupons and cash them, does not eliminate the income arising therefrom. Furthermore, the mere failure of an employee to cash a check received as compensation for services does not preclude the Government from contending that the employee received no income. Had Blair & Co., Inc., given Lockhart stock worth $800,000 as compensation for services but he had instructed them to turn the stock over to petitioner, could it be argued that he failed to receive income equivalent to the fair market value of the stock. Obviously not, and yet
49 the Board's memorandum opinion reaches the conclusion that because Lockhart did not personally exercise a right worth over $800,000 he failed to receive income.

This conclusion is squarely contrary to the decision of the Supreme Court of the United States in the case of *Corliss v. Bowers*, 281 U. S. 376, 378, where the Court said:

"The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."

The right to subscribe to the stock at a lower figure is the valuable right which is taxable income to Lockhart and this income is taxable to him whether or not he sees fit to enjoy it. In the *Erskine* case the Board stressed the right to subscribe as the determining factor—not the exercise of such right. It specifically stated (page 158) that "It has been recognized that under some conditions rights to purchase shares of stock constitutes taxable income", citing *B. F. Saul*, 4 B.T.A. 639, *James F. Shea*, 11 B.T.A. 557 and *Moran v. Lucas*, 70 F. (2d) 546. After referring to these cases, the Board said (page 160):

"We can see no difference in principle between those cases and the instant case. There, the *rights to subscribe* for the shares of stock at less than value were received in consideration for the sale of other stock. Here, the *rights*

to subscribe for the stock at less than value were received in consideration for services performed. *The question of the taxability of the rights to receive the shares of*
50 *stock is substantially the same.*" (Italics ours)

That the Board opinion erred in holding that no income resulted to Lockhart merely because technically he failed to personally exercise the option, is evident from the admission made on pages 6 and 7 of the Commissioner's brief in this proceeding, wherein it is stated:

"Therefore, the instant case may be treated as if Lockhart himself had exercised the option and thereafter sold the stock thus acquired. If, upon such sale, Lockhart would be entitled to use the book value of the stock at the date of the exercise of the option as his cost basis, then the petitioner is similarly entitled."

The petitioner and the Commissioner being in agreement on this vital phase of the case, it seems clear that the Board should reconsider its memorandum opinion and correct it to accord with the well established principles of law, hereinbefore mentioned. Furthermore, since the Board on page 14 of his opinion has held that if Lockhart had personally exercised the option he would be entitled to his new basis upon subsequent sale, which would be fair market value of the stock at the time of exercise, it follows that the Commissioner agrees that "petitioner is similarly entitled."

The opinion of the Board also ignores the provisions of Section 213 (a), 1926 Act, applicable to the year 1927 here involved. Said subdivision reads:

"(a) The term 'gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the owner-
51 ship or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period."

The Board, various Circuit Courts of Appeal, and the Supreme Court of the United States have all given the above provision a broad and far-reaching construction. Such was the effect of the Supreme Court decision in *Corliss v. Bowers,* cited on page 16 hereof. The original brief filed in behalf of petitioner in this appeal cites many cases involving stock acquisition contracts between corporations and employees similar to that before the Board in this appeal In those decisions the Board and Circuit Courts of Appeal all cited and referred to said Section 213 (a) of the 1926 and earlier Acts as warranting the conclusion that the value of the stock received under such arrangements, constituted taxable income to the recipient employee or officer. The opinion herein of August 28, 1935 is contrary to said specific provision of the law.

Petitioner accordingly submits that the Board should reconsider its memorandum opinion and find that on the evidence before it, Lockhart realized taxable income in 1925 under the original and amended option; that the amount of such income, which was compensation for services, was the difference between the fair market value of the stock covered by the option ($1,452,800) and the price to
52 be paid under such option ($617,462.27); that Lockhart's cost or basis in the event he subsequently disposed of the option would be the fair market value thereof or $835,337.73; and that petitioner is accordingly entitled to Lockhart's cost of $835,337.73 plus $617,462.27 which it paid for the stock or a total cost of $1,452,800.

III

The Board's Opinion Erred in Ignoring Portions of Paragraphs 10 and 11 of the Stipulation.

In the concluding paragraph of its memorandum opinion, the Board states (pages 15 and 16):

"We find ourselves unable to comply with the stipulation of the parties that the items of $223,602 and $14,581.33 should be included in the 'cost' to Lockhart, if the parties used the word 'cost' as the equivalent of basis since it is in conflict with paragraph (15) of the stipulation, the effect thereof is largely a conclusion of law, depriving the Board of its prerogative to determine for itself, upon the facts, whether such items are properly includable in the basis

under the statute, and, furthermore, it appears from a consideration of the actual facts as stipulated that to include such items in the basis we have established, would result in an erroneous determination."

Paragraph 10 of the stipulation states that the item of $223,602 appearing as a credit in reduction of the acquisition price of 6,400 shares of Blair & Co., Inc. stock represents the value of a dividend paid in preferred stock in 1925 by Blair & Co., Inc. on its common stock. The credit
53 was made in favor of Lockhart, who at that time had the right to acquire the common stock of Blair & Co., Inc. and the sum was used in reduction of the purchase price. Paragraph 10 then specifically states "Said sum of $223,602 represents an amount to be included in the cost to Henry Lockhart, Jr.—the transferor to petitioner—of the aforementioned option or right."

As the owner of the right to acquire the aforementioned stock of Blair & Co., Inc., Lockhart was entitled to the proceeds of 100 shares of said stock which were disposed of for $14,581.33. Paragraph (11) of the stipulation specifically states, "Said sum of $14,581.33 was applied by Blair & Co., Inc., in reduction of the price to be paid by petitioner for the acquisition of the aforementioned common capital stock of Blair & Co., Inc. and is to be included in the cost to Henry Lockhart, Jr. of said option or right to acquire common capital stock of Blair & Co., Inc."

The Board opinion has ignored these stipulated *facts* on the theory that they are in conflict with the paragraph (15) of the stipulation and that they are largely conclusions of law. Petitioner submits that the Board's determination is clearly erroneous.

In the first place, Paragraph (15) of the Stipulation makes no reference to Lockhart's cost and simply provides that certain steps should be followed if the Board holds that *petitioner's* cost of $617,462.27 is to be increased by the items of $223,602.00 and $14,581.33. Whether
54 petitioner's cost is to be increased by these items is a question of law, but Lockhart's cost of the option or right is a plain and simple question of fact.

Lockhart clearly rendered services and gave Blair & Co., Inc. valuable consideration for the original option, the

amended options and the benefits accruing thereunder. What he was paid for these services is a question of fact. The parties have stipulated that during the year 1925 Lockhart received credit for two items, namely, $223,602 and $14,581.33 on the purchase price of stock under these options. These credits were valuable property rights and increased the value of Lockhart's option or right by $238,-138.33. These property rights were applied on the option purchase price and were in fact "cost" of said option or right to acquire the common capital stock of Blair & Co., Inc.

The Board in numerous cases has recognized that cost figures may be stipulated. In *C. V. Securities Corp.*, 28 B.T.A. 914, the Board recognized that the cost of stock rights, although difficult of determination, is a conclusion of fact and may be stipulated in a proceeding before the Board and said (page 915):

"In computing the cost of the stock rights sold by the petitioner in 1928, the values of the stock and rights on December 20, 1925, and November 12, 1928, and the percentages of cost applicable to the said stock and rights on those dates, as shown by the deficiency letter, are stipulated to be correct."

In 21 Columbia Law Review, at page 419, a conclusion of law is defined:

"A conclusion of law is a generic statement which
55 can be made only after some legal rule has been applied to some specific group of operative facts."

At page 25 of 23 Yale Law Journal, Prof. Hohenfeld of Yale states:

"An ultimate fact is a conclusion drawn from intermediate and evidentiary facts."

On the basis of these authoritative definitions, Lockhart's cost—what he gave up in return for the options or rights, is a conclusion of fact; it is not a conclusion of law because its determination is not fraught with the necessity of applying a legal rule to the operative facts. The parties to the stipulation specifically recognized this in refraining from stating that the aforementioned items were to be included in petitioner's cost, since this would have required a determination and conclusion that under the law peti-

tioner's cost is to be based on Lockhart's cost. That is a conclusion of law to be decided by the Board or the Courts.

In this connection petitioner desires to call the Board's opinion to the recent decision of the Supreme Court of the United States in the case of *General Utilities and Operating Company v. Helvering,* decided December 9, 1935 and reported at Par. 2167 of 1935 Prentice-Hall Federal Tax Service. In that case, the Circuit Court of Appeals attempted to find a fact contrary to the stipulated facts and the Supreme Court said:

"Always a taxpayer is entitled to know with fair
56 certainty the basis of the claim against him. Stipulations concerning facts and any other evidence properly are accommodated to issues adequately raised."

* * * * * * * * *

"Also it made an inference of fact directly in conflict with the stipulation of the parties and the findings of the Board, for which the record affords no support whatever. To remand the case for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause." (87 L. Ed. 174, 176, 177)

Similarly, in this case the Board in failing to adopt the facts stipulated by the parties as to items to be included in Lockhart's cost, has made an inference of fact in conflict with the stipulation of the parties.

Petitioner respectfully submits that the stipulation of the parties did not deprive the Board of its prerogative to determine whether the items in question are properly includable in petitioner's basis under the statute. The Board did, however, err in disregarding the stipulated facts on the purely *fact question* of "cost" to Lockhart.

The reason assigned by the Board that the inclusion of such items in the basis to petitioner, would result in an erroneous determination, is without merit. On the contrary, the failure to include said item of $223,602.00 (and also that of $14,581.33) in Lockhart's cost, and therefore also the cost to petitioner, does result in an erroneous determination in that it ignores certain well established principles of law.

As will be noted from Paragraphs (9) and (10) of the Stipulation, the sum of $223,602.00 represents the value of a dividend in preferred stock on the common stock which Lockhart was entitled to purchase. There can be no doubt in view of the decision in *Commissioner v. Tillotson Mfg. Co.*, 76 F. (2d) 189 (1935), that the preferred stock dividend represented taxable income and not a mere
57 dilution of the common stock to which Lockhart was entitled.

In the *Tillotson* case the Board (27 B.T.A. 913) and the Appellate Court held that a dividend in a class of stock other than held, would represent taxable income for the reason that there was a difference in the character of the stock received. At page 190, the Court quoted from *Weiss v. Stearn*, 265 U. S. 242, and pointed to this statement as fundamental in its decision:

"The Court again declared that to constitute gain 'separated from the original capital interest,' the stockholder must receive 'a thing' really different from what he theretofore had."

The preferred stock having a value of $223,602 gave Lockhart new rights that did not exist with respect to the common stock. Lockhart accordingly, in effect, received the right to a taxable dividend of $223,602 which was applied on the option price of the stock. This item was income to him in 1925 and as such became a capital item reflected in the cost of the option. Other cases decided by the Board to the same effect as the *Tillotson* case are *James H. Torrens*, 31 B.T.A. 787 and *H. C. Gowran et al.*, 32 B.T.A. 820.

Under the rule of the *Rossheim* case, *supra*, the fact that Lockhart did not acquire nominal title to the stock is unimportant. There the Board squarely rejected the premise of the dissent that because petitioner was not given shares of stock by the option contract, the actual
58 purchase price of the stock should be used as a basis for computing his gain. Under the rule of that case, it was not necessary that Lockhart have title to the shares before the Board can find that the credits of $223,602 and $14,581.33 represented income received by him in 1925.

The 60-day letter of June 1, 1931, to petitioner did not

hold that Mr. Lockhart had no cost for said option. It merely stated—thus framing the issue for the Board—that:

"Since the cost of the option to Mr. Lockhart, Jr. has not been established, no value is allowable in arriving at the profit from the sale of the stock."

Thereafter, the parties in this appeal submitted "Stipulation of Facts" and in paragraphs (10) and (11) thereof it was specifically agreed that the items of $223,602.00 and $14,581.33 were "to be included in the cost of Henry Lockhart, Jr.",—the transferor to petitioner. Clearly the determination of the respondent that petitioner failed to establish the cost of the option to Henry Lockhart, Jr. was to that extent met by said *Stipulation* of the parties, entered into in good faith. It is submitted that such was a fact question "accomodated",—within the spirit of the Supreme Court decision in *Gen. Utilities Operating Co., supra,*—to the issue raised by the 60-day letter. Therefore, the Board should, and may not, disregard said stipulated facts.

Petitioner accordingly submits that if the Board should erroneously adhere to its original position that the
59 excess ($835,337.73, see p. 18, supra, and para. 16, Stipulation) of the fair market value of the 6,400 shares of Blair & Co., Inc. on December 30, 1925 over the purchase price, was not income to Lockhart in 1925, then in the alternative it should find that the cost of the option to Lockhart was at least $238,138.33, represented by the aforementioned two credit items. In either event, it is clear that under Section 204 (a)(8), Revenue Act of 1924, petitioner's cost of the stock is to be increased by Lockhart's cost of the option.

Conclusion

It is respectfully requested that the Board carefully consider this memorandum, the Stipulation of Facts and the Commissioner's brief. It is believed that thereafter it will have no hesitancy in deciding that its original memorandum opinion should be reconsidered and revised to accord with the actual facts and applicable decisions. In the alternative

the Board should grant the petitioner a rehearing in this proceeding.

Respectfully submitted,

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Counsel for Petitioner.

(Sgd) HAROLD O. WALKER,
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60 United States Board of Tax Appeals

Docket No. 59409.

MERHENGOOD CORPORATION, (DEL.), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Order and Decision

This proceeding was called from the Day Calendar of January 22, 1936 for hearing under Rule 50. Prior thereto the petitioner filed a motion for reconsideration and rehearing with a memorandum in support thereof. This motion was set for hearing on the above date. The parties waived argument thereon. After consideration of said motion and the grounds in support thereof, it is

ORDERED: That said motion be and the same is hereby denied, and it is further

ORDERED and DECIDED: That there is a deficiency in income tax of $23,146.92 for the year 1927.

ENTER:

(Signed) LOGAN MORRIS
Member.

(Seal) U. S. Board of Tax Appeals 1924

ENTERED FEB 5 1938

61 United States Board of Tax Appeals

Filed May 1, 1936

Endorsed: United States Board of Tax Appeals

Docket No. 59409

MERHENGOOD CORPORATION, (DEL.), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Agreement for Review by the United States Court of Appeals for the District of Columbia.

It is stipulated and agreed between the parties to this proceeding by their respective undersigned attorneys, that pursuant to the provisions of Section 1002 of the Revenue Act of 1926 as amended by Section 519 of the Revenue Act of 1934, the decision of the United States Board of Tax Appeals in the above described proceeding may be reviewed by the United States Court of Appeals for the District of Columbia.

PAUL E. SHORB
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Washington, D. C.
Counsel for Petitioner.

Sgd. ROBERT H. JACKSON
Assistant Attorney General
Counsel for Respondent.

62 Endorsed: United States Board of Tax Appeals

Filed May 2, 1936

United States Court of Appeals for the District of Columbia

B. T. A. Docket No. 59409

MERHENGOOD CORPORATION, (DEL.), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for Review of Decision of the United States Board of Tax Appeals, by the United States Court of Appeals for the District of Columbia.

To the United States Court of Appeals for the District of Columbia:

The above-named petitioner, Merhengood Corporation (Del.), is aggrieved by the decision of the United States Board of Tax Appeals, rendered against it on February 5, 1936, in the case of Merhengood Corporation (Del.) v. Commissioner of Internal Revenue, Number 59409, on the docket of the Board, and respectfully submits its Petition for Review thereof by the United States Court of Appeals for the District of Columbia, pursuant to a stipulation entered into by the parties under the provisions of Section 1002, Revenue Act of 1926, 44 Stat. 110, (as amended by Section 519, Revenue Act of 1934), that review shall be by said Court, which stipulation was filed with the Clerk of said Board of Tax Appeals. For cause, the petitioner respectfully shows as follows:

63 *Statement of Nature of the Controversy*

1. Petitioner is a Delaware corporation with its principal office at 44 Wall Street, New York City. On July 24, 1931, petitioner duly filed with the United States Board of Tax Appeals (hereinafter called the Board) a petition for redetermination of a deficiency of $23,146.92 in income taxes, determined by respondent against petitioner for the year 1927. This proceeding was docketed as Number 59409. An amended petition was filed on November 24, 1933 at the

hearing before the Board. Answers to the aforesaid petitions were filed by respondent. The facts were stipulated by the parties to the proceeding.

2. The primary question in controversy before the Board was the basis to be used by petitioner in determining the profit on the sale by it of stock in Blair and Company in 1927. The answer to this question depended on: (a) Whether the rights, to purchase Blair & Co., Inc. stock at less than market value, received under option by petitioner's transferor, Henry Lockhart, Jr., (hereinafter called Lockhart) constituted compensation for his services; (b) Whether the said rights so acquired represented taxable income to Lockhart; (c) Whether the income realized by Lockhart, under the contract of employment was the difference between the fair market value of the stock covered by the option and the price to be paid therefor by the terms of the option; (d) Whether the cost of
64 the said Blair & Co., Inc. stock to petitioner was the cash paid by petitioner therefor plus the cost of said option to Lockhart, transferor thereof to the petitioner.

Prior to December 31, 1924, Lockhart had been interested in the investment banking field and had successfully organized, financed and developed several corporations. Late in 1924, Blair & Co., Inc., through its president, offered Lockhart as an inducement for the latter to become an officer and Director in Blair & Co., Inc. and enter its employ, the right to acquire 5000 shares of the common capital stock of Blair & Co., Inc. at the book value thereof on December 31, 1924, which was approximately $158.00 per share. Early in 1925, Lockhart accepted the terms of employment and became an officer and director of Blair & Co., Inc. Lockhart was unable to immediately pay for said 5000 shares of stock, and the right to acquire said stock on the basis of its book value as of December 31, 1924, was from time to time extended. It was finally fixed on December 30, 1925 by Blair & Co., Inc. at 6400 shares of the common capital stock of the company for a cash payment of $617,462.27. In arriving at said number of shares and cash payment figure, certain stock adjustments were taken into account and Lockhart was given credit for $223,602.00, representing "stock dividend in preferred on common" in 1925. Blair

& Co., Inc. was willing to give Lockhart this exten-
65 sion of time for exercise of the right because he was in its employment.

On December 30, 1925, petitioner acquired from Lockhart, said option to purchase the aforementioned 6400 shares of stock for $617,462.27. For said option, petitioner issued to Lockhart, 3000 shares of its common capital stock without nominal or par value, which shares were its only issued and outstanding stock on that date. Pursuant to the terms of said option, petitioner, on December 31, 1925, acquired said 6400 shares of Blair & Co., Inc. stock by a cash payment of $617,462.27. On the aforesaid acquisition date said stock of Blair & Co., Inc. had a book value of $227.00 per share and the total book value of the acquired 6400 shares was $1,452,800.00

In 1927, petitioner sold 3948 shares of said common and 512 shares of preferred stock of Blair & Co., Inc. for $537,839.68. Petitioner reported a loss on the sale of said stock in its 1927 return. Respondent, in determining that petitioner realized a profit of $209,422.25 in the disposition of said 3948 shares of common stock and said 512 shares of preferred stock, used as a basis for petitioner's cost only the proportionate part of the $617,462.27 cash paid by petitioner for said stock, or $308,418.65 for the 3948 shares of common stock and $19,998.78 for the 512 shares of preferred stock. No portion of the option cost was included by respondent in petitioner's cost.

Petitioner claimed and averred before the Board:
66 (a) that the proper basis for determining gain or loss on the 1927 sale of said 3948 shares of common and 512 shares of preferred stock was a proportionate part of $1,452,800.00 representing (1) $835,337.73 the value and cost of Lockhart's option on December 30, 1925 plus (2) the $617,462.27 cash paid by petitioner for said 6400 shares of common capital stock, or (b) that if the Board found that the said $1,452,800.00 did not represent the cost to petitioner of the aforesaid 6400 shares of common capital stock of Blair & Co., Inc., then, in the alternative, petitioner's cash payment therefor of $617,462.27 should be increased by $223,502.00 and/or $14,581.33. Said amounts were applied by Blair & Co., Inc. in reduction of the price to be paid

by petitioner in the acquistion of the aforementioned shares of stock of Blair & Co., Inc. and the parties stipulated before the Board that said amounts were to be included in the cost to Lockhart of his option to acquire common capital stock of Blair & Co., Inc. Petitioner also claimed and averred that said $223,502.00 credit, designated "Stock Dividend in Preferred on Common" was in fact a taxable dividend to Lockhart in 1925 and accordingly part of Lockhart's and petitioner's cost of the aforementioned option.

Under contention (a) hereinabove referred to, petitioner claimed and averred before the Board that Lockhart realized taxable income in 1925 under the contract of employment, amounting to $835,337.73, the difference be-
67 tween the fair market value of the stock covered by the option ($1,452,800.00) and the price to be paid therefor under its provisions ($617,462.27).

3. On August 28, 1935, the Board entered a memorandum opinion by Member Morris under which judgement was to be entered under rule 50. On February 5, 1936, the Board denied petitioner's motion that the Findings of Fact and Memorandum Opinion in the case be Reopened, Reconsidered and Revised; that the principle of *Tillotson Manufacturing Company* v. *Commissioner,* 76 F. (2d) 189, be applied and further hearing granted. On that day the Board entered its formal decision determining a deficiency in petitioner's income tax of $23,146.92 for the year 1927, the same amount as proposed by respondent. By this decision, the Board affirmed the determination of respondent that petitioner's cost for the 6400 shares of common capital stock of Blair & Co., Inc. acquired in 1925 was only $617,-462.27, and that $328,417.43 thereof represents the cost basis for determining the gain or loss on the portion of said stock sold in 1927.

The Board also held (a) that it is doubtful whether the rights Lockhart received under the option constituted compensation for services; (b) that even if these rights were compensation for services, Lockhart realized no taxable income therefrom and, (c) that the amounts which the parties stipulated should be included in Lockhart's cost ($223,502.00 and/or $14,581.33) should be disregarded.

68 *Assignments of Error.*

The petitioner believes and avers that errors were committed by the Board to its damage and prejudice as follows:

1. In entering judgement for the respondent.
2. In failing to enter judgement for petitioner.
3. In determining the deficiency as $23,146.92 for 1927.
4. In failing to find and hold that the basis or cost to petitioner of 6400 shares Blair & Co., Inc. common stock was $1,452,800.00, consisting of (a) $835,337.73 the value and cost of Lockhart's option plus, (b) $617,462.27 cash paid by petitioner, as was established by the evidence adduced at the hearing held before the Board.
5. In the alternative, the Board erred in failing to find and hold that petitioner's cost of 6400 shares should be increased by $223,502.00 and $14,851.33, which amounts the parties stipulated were to be included in the cost to Lockhart of the option to acquire said shares.
6. In failing to find and hold that the basis or cost to petitioner for determining gain or loss on the sale of 3948 shares common and 512 shares preferred stock of Blair & Co., Inc., in 1927 was $772,719.03, as was established by the evidence adduced at the hearing held before the Board.
7. In failing to find and hold that the rights which Lockhart received under the option from Blair & Co., Inc. constituted compensation for services rendered by Lockhart under the employment agreement.
8. In disregarding the Stipulated Facts (Par. 2)
69 before the Board, that the original option was granted Lockhart "as an inducement to the latter's becoming an officer and director in Blair & Co., Inc. and entering its employ, * * * "
9. In disregarding the Stipulated Facts (Par. 3) before the Board, that the amended options were given to Lockhart by Blair & Co., Inc. "because he was in its employment."
10. In holding that Lockhart, by assigning the option to petitioner and failing to personally exercise the option to purchase the stock "committed no act upon which a tax might be predicated."

11. In failing to find and hold that the sum of $835,337.73, which the parties stipulated was the fair market value of the right to acquire the Blair & Co., Inc. stock on December 30, 1935, was taxable income to Lockhart in 1925.

12. In the alternative the Board erred in failing to find and hold that the sums of $223,502.00 and $14,851.33, which were credited to the account of Lockhart by Blair & Co., in 1925 were taxable income to Lockhart in said year.

13. In disregarding the Stipulated Facts before the Board that (paragraph 10) "said sum of $223,602 represents an amount to be included in the cost of Henry Lockhart, Jr.—the transferor to petitioner—of the aforementioned option or right."

14. In disregarding the Stipulated Facts before the Board that (paragraph 11) "Said sum of $14,581.33 is to be included in the cost to Henry Lockhart, Jr. of said option or right to acquire common capital stock of Blair & Co., Inc."

15. In failing to find and hold that the sum of
70 $223,602.00 applied by Blair & Co., Inc. in 1925 on Lockhart's option price of the stock was a taxable dividend and not a stock dividend.

16. In determining that petitioner realized a profit of $209,422.25 on the sale of 3948 shares of common and 512 shares of preferred stock of Blair & Co., Inc. in 1927, because said determination is not supported by the evidence and is contrary to the evidence adduced at the hearing held before the Board.

17. In failing to find and hold that petitioner realized no gain in 1927 on the disposition of the aforementioned stock as was established by the evidence adduced at the hearing held before the Board.

WHEREFORE, your petitioner prays that the decision of the Board entered herein against it, be reviewed and reversed by the United States Court of Appeals for the District of Columbia and that the Clerk of the Board be directed to transmit and deliver to the Clerk of said Court certified copies of all the documents necessary and material to the presentation and consideration of the foregoing Petition for Review, and as required by the rules of said Court and statutes made and provided; and your petitioner prays

for such other and further relief as the Court may deem proper in the premises.

PAUL E. SHORB
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Of Counsel:
COVINGTON, BURLING, RUBLEE,
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71 DISTRICT OF COLUMBIA, *ss:*

Paul E. Shorb, being duly sworn, says that he is attorney-of-record for the petitioner, Merhengood Corporation (Del.), and as such is duly authorized to verify the above and foregoing Petition for Review to the United States Court of Appeals for the District of Columbia; that he has read said Petition for Review, is familiar with the statements therein contained and the facts therein stated are true to the best of his information and belief.

PAUL E SHORB

Subscribed and sworn to before me this 1st day of May, 1936.

VIOLA M CURTIS
(Seal) *Notary Public, D. C.*

My commission expires Nov. 16, 1939.

72 Endorsed: United States Board of Tax Appeals

Filed May 2, 1936

United States Board of Tax Appeals

B. T. A. Docket No. 59409

MERHENGOOD CORPORATION, (Del.), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Notice of Filing Petition for Review.

HERMAN OLIPHANT, ESQ.,
General Counsel for the Department of the Treasury
Washington, D. C.

Sir:

You are hereby notified that on May 2, 1936, a petition for review of the decision of the United States Board of Tax Appeals in the above-entitled proceeding was filed with the Clerk of the Board, a true copy of which is herewith served upon you.

PAUL E. SHORB
701 Union Trust Building
Washington, D. C.
Attorney for Petitioner.

Receipt of copy of petition for review and copy of this notice acknowledged this 2nd day of May, 1936.

HERMAN OLIPHANT
General Counsel for the Department of the Treasury
Attorney for Respondent.

73 Endorsed: U. S. Board of Tax Appeals
Filed at Hearing Nov 24, 1933

United States Board of Tax Appeals

Docket No. 59409

MERHENGOOD CORPORATION, (Delaware), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Stipulation of Facts

It is hereby stipulated and agreed by and between the parties hereto, by and through their respective counsel, that the following facts may be taken and regarded as true, the same as if said facts had been proved by competent evidence introduced at the hearing of this appeal; provided, however, that there is reserved to each party the right to object to the relevancy, and materiality of said facts, and the right to introduce evidence of such other and further facts as may be proper.

(1) The petitioner is a corporation organized on December 30, 1925, under the laws of the State of Delaware, with its principal business office at Room 2205, 44 Wall Street, New York City. The notice of deficiency, a true copy of which was attached to the petition heretofore filed in this proceeding, and marked Exhibit A, was mailed to the petitioner on June 1, 1931, and said 60-day defi-

74 ciency letter is incorporated herein and made a part hereof by reference.

(2) Prior to December 31, 1924, Henry Lockhart, Jr. had been interested in the investment banking field and had successfully organized, financed and developed several corporations. Late in 1924 Elisha Walker, President and a director of Blair & Co. Inc., conferred with Lockhart about coming with the latter corporation as an officer and director. Elisha Walker, in behalf of Blair & Co. Inc. offered to Henry Lockhart, Jr., as an inducement to the latter's becoming an officer and director in Blair & Co. Inc., and entering its employ, the right to acquire 5,000 shares of the common capital stock of Blair & Co. Inc. at the asset value

thereon on December 31, 1924, which was about $158.00 per share. The arrangement did not obligate Henry Lockhart, Jr. to purchase said stock but gave him only the right to do so on said basis.

(3) Henry Lockhart, Jr. accepted the terms of employment by Blair & Co. Inc. and became an officer and director thereof early in 1925. Lockhart was unable to immediately pay for said 5,000 shares of stock of Blair & Co. Inc., and the right to acquire said common capital stock of Blair & Co. Inc. on the basis of its book value as of December 31, 1924, was from time to time extended, and was finally fixed on December 30, 1925, at 6,400 shares of the common capital stock of Blair & Co. Inc. Blair & Co. Inc. was
75 willing to give Lockhart this extension of time for exercise of the right because he was in its employment. The original right to acquire common capital stock of Blair & Co., Inc. was for 5,000 shares, but due to stock dividends and other stock adjustments, the right on December 31, 1925, applied to 6,400 shares of the common capital stock of Blair & Co. Inc.

(4) Blair & Co. Inc. paid Henry Lockhart, Jr. in 1925 a salary of $25,000.00 and a like amount in 1926. His compensation in 1927, 1928, 1929 and 1930 was $35,000.00 per annum, and he was paid in 1928 a commission of $16,634.82. His employment by Blair & Co. Inc. was terminated about December 31, 1930.

(5) The arrangement made by Henry Lockhart, Jr. with Elisha Walker for the employment by Blair & Co. Inc. of the former as one of its officers and directors did not commit Henry Lockhart, Jr. to any definite period of employment. The arrangement was no part of a general corporate plan but applied only to Henry Lockhart, Jr. and did not apply to any other officer or employee of Blair & Co. Inc.

(6) The common capital stock of Blair & Co. Inc. had on December 31, 1925, a book value of $227.00 per share and 200 shares of said common capital stock sold on January 2, 1926, between a willing seller and a willing buyer at $227.00 per share. The stock was not actively traded in but it was the custom for said stock to be sold and
76 traded in at its book value.

73 Endorsed: U. S. Board of Tax Appeals

Filed at Hearing Nov 24, 1933

United States Board of Tax Appeals

Docket No. 59409

MERHENGOOD CORPORATION, (Delaware), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Stipulation of Facts

It is hereby stipulated and agreed by and between the parties hereto, by and through their respective counsel, that the following facts may be taken and regarded as true, the same as if said facts had been proved by competent evidence introduced at the hearing of this appeal; provided, however, that there is reserved to each party the right to object to the relevancy, and materiality of said facts, and the right to introduce evidence of such other and further facts as may be proper.

(1) The petitioner is a corporation organized on December 30, 1925, under the laws of the State of Delaware, with its principal business office at Room 2205, 44 Wall Street, New York City. The notice of deficiency, a true copy of which was attached to the petition heretofore filed in this proceeding, and marked Exhibit A, was mailed to the petitioner on June 1, 1931, and said 60-day deficiency letter is incorporated herein and made a part hereof by reference.

74

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thereon on December 31, 1924, which was about $158.00 per share. The arrangement did not obligate Henry Lockhart, Jr. to purchase said stock but gave him only the right to do so on said basis.

(3) Henry Lockhart, Jr. accepted the terms of employment by Blair & Co. Inc. and became an officer and director thereof early in 1925. Lockhart was unable to immediately pay for said 5,000 shares of stock of Blair & Co. Inc., and the right to acquire said common capital stock of Blair & Co. Inc. on the basis of its book value as of December 31, 1924, was from time to time extended, and was finally fixed on December 30, 1925, at 6,400 shares of the common capital stock of Blair & Co. Inc. Blair & Co. Inc. was
75 willing to give Lockhart this extension of time for exercise of the right because he was in its employment. The original right to acquire common capital stock of Blair & Co., Inc. was for 5,000 shares, but due to stock dividends and other stock adjustments, the right on December 31, 1925, applied to 6,400 shares of the common capital stock of Blair & Co. Inc.

(4) Blair & Co. Inc. paid Henry Lockhart, Jr. in 1925 a salary of $25,000.00 and a like amount in 1926. His compensation in 1927, 1928, 1929 and 1930 was $35,000.00 per annum, and he was paid in 1928 a commission of $16,634.82. His employment by Blair & Co. Inc. was terminated about December 31, 1930.

(5) The arrangement made by Henry Lockhart, Jr. with Elisha Walker for the employment by Blair & Co. Inc. of the former as one of its officers and directors did not commit Henry Lockhart, Jr. to any definite period of employment. The arrangement was no part of a general corporate plan but applied only to Henry Lockhart, Jr. and did not apply to any other officer or employee of Blair & Co. Inc.

(6) The common capital stock of Blair & Co. Inc. had on December 31, 1925, a book value of $227.00 per share and 200 shares of said common capital stock sold on January 2, 1926, between a willing seller and a willing buyer at $227.00 per share. The stock was not actively traded in but it was the custom for said stock to be sold and
76 traded in at its book value.

(7) The book value of said common capital stock on December 31, 1924, was $158.778 per share and the petitioner in setting up on its books the value of said stock acquired by it on December 31, 1925, used said December 31, 1924, book value of $158.778 per share instead of its book value of $227.00 per share on the acquisition date, to-wit, December 31, 1925.

(8) Petitioner on December 30, 1925, acquired from Henry Lockhart, Jr., an option to purchase 6,400 shares of the common capital stock of Blair & Co. Inc. For said option petitioner issued to Henry Lockhart, Jr. 3,000 shares of its common capital stock without nominal or par value. Said 3,000 shares issued by petitioner for said option was its only issued and outstanding stock on that date. Under the terms of said option petitioner on December 31, 1925, acquired said 6,400 shares of Blair & Co. Inc. common capital stock by a cash payment of $617,462.27.

(9) The following memorandum statement represents the basis on which the aforementioned 6,400 shares of the common capital stock of Blair & Co. Inc. were acquired on December 31, 1925, from the latter by petitioner:

77 "Merhengood Corporation
In account with Blair & Co. Inc., 24 Broad St., New York

Date 1925	Memorandum			Debit	Credit
Dec. 31	Cost of 6400 Shares Blair and Company Inc. Common Stock as follows—				
	As of Jan. 1st 1925 5000 shares at 158.788		793,890.00		
	Equivalent of 6% on Premium of $29,389.00				
	From Jan. 1 1925 to Sept. 1 1925		11,755.60		
	As of Sept. 1 1925 Equivalent of 500 Shares-New-at par		50,000.00		
	As of Sept. 1 1925 1000 Shares being Equivalent of 20% stock dividend				
			$855,645.60		
	Less Equivalent at 111.801 per Share of 40% of Stock Dividend in Preferred on Common		223,602.00		
			632,043.60		
	Less Proceeds Surrendered	100 shares $14,585.33			
	Less Tax	4.00	14,581.33		
		BALANCE	DUE	$617,462.27	
	Proceeds from Blair and Company note of Merhengood Corporation				$617,462.27
				$617,462.27	$617,462.27

E AND O E
NEW YORK—DECEMBER 31st 1925."

78 (10) The item of $223,602.00 appearing as a credit in the above statement in reduction of the acquisition price of said 6,400 shares of common capital stock of Blair & Co. Inc. represents the value of a dividend paid in preferred stock during the year 1925 by Blair & Co. Inc. on its common capital stock. The petitioner did not own any of the common capital stock of Blair & Co. Inc. until December 31, 1925, and said credit of $223,602.00 represents a credit made of that sum by Blair & Co. Inc. in favor of Henry Lockhart, Jr., the owner of the aforementioned right to acquire the common capital stock of Blair & Co. Inc. and said sum was used in reduction of petitioner's purchase

price of said common capital stock as shown by the statement in paragraph (9) hereof. Said sum of $223,602.00 represents an amount to be included in the cost to Henry Lockhart, Jr.—the transferor to petitioner—of the aforementioned option or right.

(11) The item of $14,581.33 appearing as a credit on the aforementioned statement of account represents the amount realized during 1925 by Henry Lockhart, Jr. by disposition of his right to acquire 100 shares of the common capital stock of Blair & Co. Inc. Said sum of $14,581.33 was applied by Blair & Co. Inc. in reduction of the price to be paid by petitioner for the acquisition of the aforementioned common capital stock of Blair & Co. Inc. and is to be included in the cost to Henry Lockhart, Jr. of said option or right to acquire common capital stock of Blair & Co. Inc.

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(12) Blair & Co. Inc. in its 1925 Federal income tax return showed a loss in its surplus account from the disposition of said 6,400 shares of its common capital stock to the petitioner.

(13) The basis used by the Commissioner in determining profit of $209,422.25 as realized by petitioner in 1927 from disposition of 3,948 shares of common and 512 shares of preferred stock of Blair & Co. Inc. is set out in his 60-day deficiency letter notice, Exhibit A, attached to petitioner's petition heretofore filed in this appeal. The basis used by the Commissioner in said 60-day letter starts with a cost to petitioner for said 6,400 shares of common capital stock of Blair & Co. Inc. of $617,462.27, and includes no other sum therein.

(14) If petitioner's cost is $1,452,800.00, representing a cost basis for said 6,400 shares of common capital stock of $227.00 per share, or on the basis of $1,011,200.00, representing a cost basis of $158.788 per share, petitioner realized no gain in 1927 on the disposition of said 3,948 shares of common and 512 shares of preferred stock of Blair & Co. Inc. and no part of the deficiency asserted by the respondent in his 60-day deficiency notice of June 1, 1931, is due or owing from the petitioner.

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(15) If the Board holds that petitioner's cost of $617,462.27 for said 6,400 shares of common capital stock of

Blair & Co. Inc. on December 30, 1925, is to be increased by

(a) $223,602.00, and

(b) $14,581.33,

or either of said sums, the parties agree that proper adjustment is to be made in the cost of said stock and the requisite corresponding adjustment is to be made on the profit, if any, realized by petitioner in 1927 on the disposition of 3,948 shares of common and 512 shares of preferred stock of Blair & Co. Inc.—the method of said adjustment to be as heretofore determined by respondent in his 60-day deficiency notice of June 1, 1931, to petitioner with necessary adjustment made in the cost to be allocated respectively to the common and preferred stock of Blair & Co. Inc. on account of such increase as may be determined by the Board in the cost to petitioner on December 31, 1925, of said 6,400 shares of common capital stock of Blair & Co. Inc.

(16) If the Board should hold that the right given
81 to Henry Lockhart, Jr. to acquire the common capital stock of Blair & Co. Inc. as previously related herein represented at that time taxable income to him, the fair market value of said right to acquire said stock on December 30, 1925, was $835,337.73.

(17) Henry Lockhart, Jr. did not include in his taxable net income for 1925 as reported on his individual tax return for said year said sum of $835,337.73 or any part thereof, nor did he pay any individual income tax for 1925 on account thereof. Henry Lockhart, Jr. did not include in his taxable net income for 1925, as reported for his individual tax return for said year, the sum of $223,602.00 referred to in paragraph (10) hereof or the sum of $14,581.33 referred to in paragraph (11) hereof, nor did he pay any individual income tax for 1925 on account of said items or either of them.

(18) The petitioner in this appeal, Merhengood Corporation, Delaware, was organized on December 30, 1925, at the instance of Henry Lockhart, Jr. and for the purpose of acquiring the 6,400 shares of the common capital stock of Blair & Co. Inc. as referred to in subdivision (3) and other paragraphs hereof. It was necessary that money be borrowed to make payment for said 6,400 shares of the

82 common capital stock of Blair & Co. Inc. and petitioner was organized to acquire same in order to keep the interest in said stock separate from the other assets and liabilities of Henry Lockhart, Jr. Blair & Co., a banking partnership who made the loan on December 31, 1925, of $617,462.27, to petitioner, Merhengood Corporation, and took its note for said amount with the said 6,400 shares of common capital stock of Blair & Co. Inc. as collateral security therefor was desirous of having the petitioner corporation organized so that liability of Henry Lockhart, Jr. for the purchase price of said shares would be kept separate and distinct from his other assets and liabilities.

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83 Endorsed: United States Board of Tax Appeals
Filed Jun 4, 1936

United States Court of Appeals for the District of Columbia

Docket No. 59409

MERHENGOOD CORPORATION, (Del.), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Praecipe for Record

Filed June 4, 1936.

To the Clerk of the United States Board of Tax Appeals:

You are hereby requested to prepare and certify and transmit to the Clerk of the United States Court of Ap-

peals for the District of Columbia, with reference to petition for review heretofore filed by the petitioner in the above cause, a transcript of the record in the above cause, prepared and transmitted as required by law and by the rules of said Court, and to include in said transcript of record the following documents or certified copies thereof, to wit:

(1) The docket entries of all proceedings before the Board of Tax Appeals.

(2) Pleadings before the Board of Tax Appeals, as follows:

(a) Amended petition for redetermination filed No-
84 vember 24, 1933.

(b) Answer of the respondent to the amended petition filed February 7, 1934.

(3) The memorandum opinion of the Board of Tax Appeals.

(4) Motion by petitioner that findings of fact and memorandum opinion be reopened, reconsidered and revised; that the principle of *Commissioner* v. *Tillotson,* 76 F (2d) 189, be applied; and further hearing be granted.

(5) The decision of the Board of Tax Appeals.

(6) The agreement for review by the United States Court of Appeals for the District of Columbia.

(7) The petition for review, together with proof of service of notice of filing petition for review, and of service of a copy of petition for review.

(8) The stipulation of facts filed in the above cause, being all the evidence presented to the Board of Tax Appeals.

(9) This Praecipe.

PAUL E. SHORB
701 Union Trust Building
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Attorney for Petitioner.

85 United States Board of Tax Appeals
Washington

Docket No. 59409

MERHENGOOD CORPORATION, (Del.), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Certificate

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 84, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 17th day of June 1936.

B. D. GAMBLE
Clerk,
(Seal) *United States Board of Tax Appeals.*

Endorsed on Cover: Board of Tax Appeals. No. 6764. Merhengood Corporation (Del.) Petitioner, vs. Guy T. Helvering, Commissioner of Internal Revenue. United States Court of Appeals for the District of Columbia. Filed Jun 30 1936. Moncure Burke, Clerk.

UNITED STATES
COURT OF APPEALS FOR THE
DISTRICT OF COLUMBIA
FILED SEP 24 1936
Monroe Charles
CLERK

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA.

Docket No. 6764.

MERHENGOOD CORPORATION, (DEL.) *Petitioner,*

v.

GUY T. HELVERING,
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR THE PETITIONER.

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M. P. WORMHOUDT,
HOWARD C. WESTWOOD,
JOEL BARLOW,
Attorneys for Petitioner.

COVINGTON, BURLING, RUBLEE, ACHESON AND SHORB,
Of Counsel.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA.

Docket No. 6764.

MERHENGOOD CORPORATION, (DEL.) *Petitioner,*

v.

GUY T. HELVERING,
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR THE PETITIONER.

Jurisdiction.

This case comes before the Court on petition for review of the decision of the United States Board of Tax Appeals pursuant to Sections 1001-1003 of the Revenue Act of 1926, C. 27, 44 Stat. 9, as amended by Section 1101, Revenue Act of 1932, C. 209, 47 Stat.

169, and by Section 519, Revenue Act of 1934, C. 277, 48 Stat. 680. In the stipulation filed in the case (Record, page 43), it was agreed that the decision of the Board might be reviewed by the United States Court of Appeals for the District of Columbia pursuant to the provisions of Section 1002 of the Revenue Act of 1926 as amended by Section 519, Revenue Act of 1934.

The Question Presented.

This case involves the taxable year 1927. The question presented is the basis to be used by petitioner in determining gain or loss on sales in 1927 of securities acquired by petitioner in 1925 through the exercise of an option received by it in exchange for all the shares of its capital stock.

Statement of Facts.

Petitioner is a Delaware corporation, organized on December 30, 1925, with its principal office at 44 Wall Street, New York City (Record page 52).

Prior to December 31, 1924, Henry Lockhart, Jr. had been interested in the investment banking field and had successfully organized, financed and developed several corporations (R. 52). Late in 1924, Blair & Co., Inc., offered Lockhart as an inducement for the latter to become one of its officers and directors and enter its employ, the right to acquire 5000 shares of its common capital stock at the book value thereof on December 31, 1924, which was approximately $158.00 per share (R. 52, 53). Early in 1925, Lockhart accepted the terms of employment and became an officer and director of Blair & Co., Inc. Lockhart was unable to immediately pay for said 5000 shares

of stock, and the right to acquire said stock on the basis of its book value as of December 31, 1924, was from time to time extended by subsequent options (R. 53). It was finally fixed on December 30, 1925 by Blair & Co., Inc. at 6400 shares of the common capital stock of the company for a cash payment of $617,-462.27 (R. 53). In arriving at said number of shares and cash payment figure, certain stock adjustments were taken into account and Lockhart was given credit for $223,602.00, representing "stock dividend in preferred on common" in 1925 (R. 53, 55, 56). Blair & Co., Inc. was willing to give Lockhart these subsequent options extending the time for exercise of the right because he continued in its employment (R. 53). On December 30, 1925 said 6400 shares of Blair & Co., Inc. had a book value of $1,452,800.00 or $227.00 per share, 200 shares of Blair & Co., Inc. stock having been sold at $227.00 per share on January 2, 1926 (R. 53). The fair market value of the right to acquire said stock on December 30, 1925 was $835,-337.73 (R. 57).

On December 30, 1925, petitioner acquired from Lockhart, the option to purchase the aforementioned 6400 shares of stock for $617,462.27 (R. 54). For said option, petitioner issued to Lockhart, 3000 shares of its common capital stock without nominal or par value, which shares were its only issued and outstanding stock on that date (R. 54). Pursuant to the terms of said option, petitioner, on December 31, 1925, acquired said 6400 shares of Blair & Co., Inc. stock by a cash payment of $617,462.27 (R. 54).

In 1927, petitioner sold 3948 shares of said common and 512 shares of preferred stock of Blair & Co., Inc. for $537,839.68 (R. 8). Petitioner reported in its 1927

return a loss of $37,963.56 on the sale of said stock (R. 8). Respondent, in determining that petitioner realized a profit of $209,422.25 in the disposition of said 3948 shares of common stock and said 512 shares of preferred stock, used as a basis for petitioner's cost only the proportionate part of the $617,462.27 cash paid by petitioner for said stock, or $308,418.65 for the 3948 shares of common stock and $19,998.78 for the 512 shares of preferred stock (R. 8, 9). No portion of the option cost was included by respondent in petitioner's cost (R. 8).

On August 28, 1935, the Board entered a memorandum opinion under which judgment was to be entered under Rule 50 (R. 10). On February 5, 1936, the Board denied petitioner's motion that the Findings of Fact and Memorandum Opinion in the case be Reopened, Reconsidered and Revised; that the principle of *Tillotson Manufacturing Company v. Commissioner*, 76 F. (2d) 189, be applied and further hearing granted (R. 42). On that day the Board entered its formal decision determining a deficiency in petitioner's income tax of $23,146.92 for the year 1927, the same amount as proposed by respondent (R. 42). By this decision, the Board affirmed the determination of respondent that petitioner's cost for the 6400 shares of common capital stock of Blair & Co., Inc. acquired in 1925 was only $617,462.27, and that $328,417.43 thereof represents the cost basis for determining the gain or loss on the portion of said stock sold in 1927.

The Board also held (a) that it is doubtful whether the rights Lockhart received under the option constituted compensation for services; (b) that even if these rights were compensation for services, Lockhart realized no taxable income therefrom and, (c) that

the amounts which the parties stipulated should be included in Lockhart's cost ($223,602.00 and/or $14,-581.33) should be disregarded (R. 18, 19, 20). The Stipulation relating to this appears at R. 55-56.

Errors Relied Upon.

The following errors have been assigned and are relied upon. The Board erred:

1. In entering judgment for the respondent.

2. In failing to enter judgment for petitioner.

3. In determining the deficiency as $23,146.92 for 1927.

4. In failing to find and hold that the basis or cost to petitioner of 6400 shares of Blair & Co., Inc. common stock was $1,452,800.00, consisting of (a) $835,-337.73 the value on Dec. 30, 1925 and cost of Lockhart's option plus, (b) $617,462.27 cash paid by petitioner, as was established by the evidence adduced at the hearing held before the Board.

5. In the alternative to 4, *supra,* the Board erred in failing to find and hold that petitioner's cost of 6400 shares should be increased by $223,602.00 and $14,851.33, which amounts the parties *expressly stipulated* (Paragraph 10, R. 56 and Paragraph 11, R. 57, respectively) were to be included in the cost to Lockhart of the option to acquire said shares.

6. In failing to find and hold that the basis or cost to petitioner for determining gain or loss on the sale of 3948 shares common and 512 shares preferred stock of Blair & Co., Inc., in 1927 was $772,719.03, as was established by the evidence adduced by the hearing held before the Board.

7. In failing to find and hold that the rights which Lockhart received under the option from Blair & Co.,

Inc. constituted compensation for services rendered by Lockhart under the employment agreement.

8. In disregarding the Stipulated Facts (Paragraphs (2) (3), R. 52, 53) before the Board, that the original option was granted Lockhart "as an inducement to the latter's becoming an officer and director in Blair & Co., Inc. and entering its employ, * * *" and that the amended options were given to Lockhart by Blair & Co., Inc. "because he was in its employment."

9. In holding that Lockhart, by assigning the option to petitioner and failing to personally exercise the option to purchase the stock "committed no act upon which a tax might be predicated."

10. In failing to find and hold that the sum of $835,337.73, which the parties stipulated was the fair market value of the right to acquire the Blair & Co., Inc. stock on December 30, 1925, represented cost thereof to Lockhart in 1925, which under the law, was to be included in the cost to petitioner.

11. In the alternative to 10, *supra,* the Board erred in failing to find and hold that the sums of $223,602.00 and $14,851.33, which were credited to the account of Lockhart by Blair & Co., in 1925 were taxable income to Lockhart in said year.

12. In failing to find and hold that the sum of $223,602.00 applied by Blair & Co., Inc. in 1925 on Lockhart's option price of the stock was a taxable dividend and not a stock dividend.

13. In determining that petitioner realized a profit of $209,422.25 on the sale of 3948 shares of common and 512 shares of preferred stock of Blair & Co., Inc. in 1927, because said determination is not supported by the evidence and is contrary to the evidence adduced at the hearing held before the Board.

14. In failing to find and hold that petitioner realized no gain in 1927 on the disposition of the aforementioned stock as was established by the evidence adduced at the hearing held before the Board.

The Statutes and Regulations Involved.

The statutes and regulations involved will be found in the Appendix, *infra,* p. 39.

ARGUMENT.

It is petitioner's contention that Lockhart, during the year 1925, received from Blair & Co., Inc., for services rendered a valuable option to acquire stock, which option was worth on December 30, 1925 $835,-337.73; that said option constituted income to Lockhart and thus became a capital item or cost to Lockhart which carried over to petitioner in a tax-free transaction and must be included as part of petitioner's cost of said stock.

In summary terms, the Board's decision is that an option given an officer for his services is not income, that there is no income until the officer has taken the stock which he has the right to acquire under the option. Thus though the receipt of an option for which consideration has been paid be deemed by all the business world to be a valuable acquisition, the Board holds that the United States has decided not to tax that event at all but to await the optionee's convenience and to exact its due only when the stock itself is acquired—perchance in a year, nicely timed, when losses may be charged against the gain.

I.

The Board's Opinion that the Benefits and Rights Under the Original and Amended Options did not Constitute Compensation for Services is Contrary to the Record Facts and Pertinent Decisions.

While the Board did not place its decision upon the ground that the receipt of the option by Lockhart was not in consideration of his employment, the Board did say (R. 18):

> "As a matter of fact it may be doubted that whatever benefit Lockhart would have enjoyed had he exercised his option was compensation for services rendered under the reasoning of the Erskine case, (26 B. T. A. 147) for the reason that Erskine's benefit was purely prospective and entirely dependent upon the earnings of the corporation, whereas here, for all that we know, Lockhart may well have exercised his option at the very outset of his employment with Blair & Co., Inc." (Citation supplied)

The Stipulation of Facts (Paragraph (2) R. 52) shows that the original option was granted Lockhart "as an inducement to the latter's becoming an officer and director of Blair & Co., Inc. and entering its employ, * * *". The valuable amended options were given to Lockhart by Blair & Co., Inc. "because he was in its employment" (Paragraph (3) R. 53). These facts clearly establish that the valuable rights arising under the original option were given to Lockhart by Blair & Co., Inc. because he accepted the proffered terms of their employment. The valuable rights arising under the subsequent options were given to him because he continued in the company's employ-

ment during 1925 — not because he had already exercised an option which became increasingly valuable. Clearer words to establish these facts could not have been chosen, than those in the Stipulation. (R. 52-54)

Petitioner submits that the Board's disregard for the Stipulation of the parties on this point (R. 52, 53) resulted in a faulty premise which led to its erroneous decision.

There really can be no doubt that the option was compensation for services. Lockhart was a successful business man, skilled in financing and developing corporations such as Blair & Co., Inc. (R. 52) In the latter part of 1924 the president of Blair & Co., Inc. opened negotiations with Lockhart, looking to his connection with the company as an officer and director. (R. 52) To induce Lockhart to become an officer and director and to enter the company's employ, Lockhart was offered the option to purchase 5,000 shares at $158.00 each, which was the asset value thereof on December 31, 1924. (R. 52-53) Finally, early in 1925, Lockhart accepted the offer and joined with the company. (R. 53) He did not, however, agree to remain with the company for any period of time. (R. 53) The company was not disappointed in the connection, for Lockhart's salary was increased from $25,000 annually in 1925 to $35,000 annually in 1927, and in 1928 he was paid, additionally, a commission of over $16,500. (R. 53)

Lockhart was unable to take the stock on the agreed terms when he entered the company's employ (R. 53) and ultimately it was necessary to raise money by borrowing, at the end of 1925. (R. 58) At this time the company fixed an option with new terms (R. 53) and gave it to Lockhart because he was, during this

period, continuing his connection with the company. (R. 53) This option was for stock with a book and sale value of $227 per share, but the company agreed that Lockhart would have to pay only $158.00, this amount to be further reduced by credits which were given Lockhart in 1925 by Blair & Co., Inc. of $223,-602.00 and $14,851.33 (R. 53).

The statement in the Board's opinion that Lockhart could have, but did not, exercise his original option early in 1925 when he joined Blair & Co., Inc. does not in any way justify the conclusion that the original option and the amended options were not in fact compensation for services. The original option which permitted Lockhart to buy 5,000 shares of stock early in 1925 at its book value as of December 31, 1924, clearly had a value. Blair & Co., Inc. was a closely held company, and it is obvious that its stock was not available to everyone, as was the Studebaker Company stock in *Erskine v. Commissioner,* 28 B. T. A. 147. The option therefore early in 1925, when it could first have been exercised by Lockhart had a definite value. To contend that there was no employment contract because Lockhart might "have exercised his option at the very outset", is just as convincing as to argue that because an employee receives his salary at the "outset" it is not compensation for services. The amended options subsequently granted to Lockhart during 1925 whereby he was permitted on December 30, 1925 under the final option to buy 6,400 shares of Blair & Co., Inc. stock for $617,462.27 (after deducting credits of $223,602.00 and $14,581.33) were substituted for the original option and were in point of law new options. The first option gave him the right to buy 5,000 shares, the final option the right to buy 6,400

shares. That they were valuable when received is evidenced by the fact that the 6,400 shares increased in value during 1925 until on December 30, 1925, when the final option was acquired by Lockhart, they were actually worth $1,452,800.00. See Paragraph (6) of Stipulation (R. 53).

Even if it were assumed that the original option had no value, it is obvious, from the facts and figures just stated, that the subsequent modified options — certainly, the final option — had a definite value. *Each change in time and number of shares during 1925 resulted in a closed transaction which gave rise to income to Lockhart. Each change in effect created a new option contract which Lockhart could have disposed of at an increasingly greater price. Even if it were doubted that the earlier options were valuable, the facts in the record establish beyond doubt that the final option was valuable. The parties stipulated (Stipulation, Paragraphs (6) (16) R. 53, 57) and the Board found (R. 11) that the stock covered by the final amended option had a book value of $227 per share. This gave the option a value of $835,337.73.*

The Board's opinion attempts to distinguish the *Erskine* case, *supra,* on the theory that Erskine's benefit was purely prospective and entirely dependent on the earnings of the corporation. This distinction is not, however, well taken. Petitioner recognizes of course, that Board decisions are not precedents for this Court, and they are referred to in this brief for the sole purpose of illustrating that the Board, in attempting to distinguish its prior decisions, misinterpreted the facts of this case and, in effect, employed faulty premises in applying the rules of the decisions relied upon in its opinion.

An analysis of the *Erskine* case clearly shows that it was not the fact that Erskine's benefit was uncertain or prospective that induced the Board to conclude that the benefit was compensation for services. The fact that the benefit was prospective and could not be determined until the end of the year was the reason given by the Board for holding, *not* that Erskine received compensation for services, but that Erskine received no benefit at the time of the acquisition of the contracts. If, as in the instant case, Erskine had been given a new option without any conditions attached a few months later when the market value had increased, the plain implication of the Board's decision (p. 162, 163) is that they would have held that he realized income in the form of compensation at the time such option was granted. The Board had already determined in the earlier paragraphs of its opinion that the contract between Erskine and the corporation was an employment contract. Simply from a logical standpoint, certainty or uncertainty of payment should not be controlling or even compelling factors in determining if payment is compensation. As a matter of fact, certainty of payment is more often identified with employment contracts than speculative payments.

Finally, if the benefits which accrued to the petitioner under the original option and the amended options were not compensation for services, what were they?

The option was not part of a corporate sale plan.

The evidence shows (Par. (5) of the Stipulation) (R. 53) that the option to purchase was not a purchase by an officer under a corporation sale plan. How

identically this parallels the situation in the *Erskine* case is shown by the excerpt from the Board's opinion in that case (page 161):

> "The agreement under which the petitioner received his rights was not part of a general corporate plan. It included no other officer or employee."

The transaction was not a sale of stock.

Likewise under the test laid down by the Board in the *Erskine* case, the agreement between Lockhart and Blair & Co., Inc. was not a sale. (page 161):

> "He assumed no risk in the possible event of a subsequent decline in the market value of the shares below the price named in the agreement because he was under no obligation to purchase them."

and for this reason the Board went on to conclude:

> "* * * We cannot regard the substance of the transaction here merely as a purchase and sale."

The evidence in the instant case shows that "the arrangement did not obligate Henry Lockhart, Jr. to purchase said stock but gave him only the right to do so on said basis." (Stipulation Par. (2)) (R. 52, 53) Thus, under the above stated rule in the *Erskine* case, the transaction with Blair & Co., Inc. cannot be regarded as a purchase and sale.

The transaction was not a gift.

Since the arrangement between the parties was not a sale, the only other question which arises is "Was the transaction a gift?" In answering this question,

we may again turn to the *Erskine* case where the Board said (page 157):

> "The officers and directors of the corporation had no lawful right to make a gift to the petitioner of any part of the value of the shares of stock, or to 'sell' them at a price known to be considerably less than their cost or market value. We must assume that the officers and directors did not act unlawfully. Noel v. Parrott 15 F. (2d) 669."

Likewise, in *Rossheim v. Commissioner,* 31 B. T. A. 857 when confronted with a factual situation like that of the present case and the *Erskine* case, the Board at page 867 referred to *Noel v. Parrott, supra,* and reiterated its former statement:

> "So we must assume here that the officers and directors did not act unlawfully."

If the Board could not assume that the officers and directors acted unlawfully in the *Rossheim* and *Erskine* cases, there is no reason why it should assume that the officers and directors of Blair & Co., Inc. did act unlawfully and made a gift or gifts in the present case.

Since the valuable options in the case of this petitioner were not sales or gifts, the only alternative is that they were compensation for services in connection with a contract of employment. This conclusion is squarely in accord with the facts and the logic of other pertinent cases. As stated heretofore, the record definitely shows (Stip. Pars. (2) and (3)) (R. 52, 53) that the valuable original option was granted Lockhart "as an inducement to the latter's becoming an officer and director in Blair & Co., Inc., and entering

its employ" and that the increasingly valuable amended options were given to Lockhart by Blair & Co., "because he was in its employment." These are the stipulated facts but they were ignored by the Board.

The fact that the agreement in this case did not take the form of a written formal contract does not preclude it from being a contract of employment as is well stated by the Board in *Rossheim v. Commissioner, supra,* page 867.

The fact that Lockhart received a salary as well as the option does not prevent the latter from being compensation for services. As stated by the Board in the *Erskine* case (page 155):

> "The contract does not expressly limit petitioner's total compensation to $100,000 per year. It merely provides for a fixed yearly salary of that amount."

Lockhart's promise to serve and the services subsequently rendered Blair & Co., Inc. are the only consideration which Blair & Co., Inc. received for the valuable options. The record clearly shows this to be the case. The identical consideration existed in the *Erskine* and *Rossheim* cases, the Board stating in the latter case (page 867):

> "Here the consideration moving from petitioner to the corporation was services."

Services being the valid consideration for the valuable options, how can it be doubted that the benefits arising under the options were actually compensation for services.

No conclusion to the whole matter could be more pertinent, nor any statement more exactly appropriate

to the facts of the case now before the Court than the following passages from the Board's opinions in the *Rossheim* and *Erskine* decisions:

> "Taxation is a practical matter and we must look to the substance rather than the form. Business men acting as directors and officers do not ordinarily give away the funds in corporate treasuries without adequate consideration. We are well satisfied that the petitioner would not have been given the option in question if he were not president of the corporation, under all the facts and circumstances as shown by the proof." (p. 867, *Rossheim* v. *Commissioner, supra*)
>
> "The agreement itself, which appears in full above, bears all of the essential characteristics of an ordinary employment contract. The petitioner was to serve as president of the corporation, or in some position of equal dignity, for a period of between four and five years beginning January 1, 1922, and was to receive a fixed annual salary of $100,000 and further consideration in the form of rights to acquire certain shares of the stock of the corporation at an advantageous price. * * * (p. 161, *Erskine* v. *Commissioner, supra*).

It is respectfully submitted that this Court should accordingly reverse the decision of the Board which disregarded the stipulation of the parties, and hold that there can be no doubt that the rights and benefits which accrued to Lockhart in 1925 under the original and the amended options were compensation for services.

II.

Lockhart Realized Taxable Income During 1925 When He Had the Right to Exercise the Original and Later Options.

On page 13 of the memorandum opinion handed down in this case, the Board makes this statement: (R. 18)

> "Even conceding that Lockhart's benefit should be classified as compensation for services rendered, and that the *Erskine* case is similar to that extent, for the same result must be reached in any event; we disagree with petitioner's argument that Lockhart realized taxable income under his option."

The Board's opinion attempts to justify this conclusion by reasoning that an option is merely an offer looking forward to acceptance, which is the exercise thereof and until it is exercised or revoked, it remains an offer. It is also stated that there was no compulsion whatever upon Lockhart to exercise the option and therefore the Board and the Courts would have disapproved any effort to tax him upon the income resulting from his right to exercise the options.

This conclusion is fundamentally unsound and erroneous. While it should not be necessary to discuss the nature of an option in this brief, it is clear that the efforts in the Board's opinion to classify the options as mere offers is quite beside the point. Likewise the fact that Lockhart could refrain from exercising the option has absolutely no bearing on the case. The only important question is, did Lockhart receive an enforcible valuable right against Blair & Co., Inc. during 1925 when he received the original

and amended options. It is clear he had given the company the necessary consideration, namely, entering its employ and continuing in its employment. This being true, Williston at Section 61, page 106, in his treatise on contracts states the law as follows:

> "So if consideration is paid for an offer though no seal is attached, the offer is a contract. Such contracts are generally called options."

Likewise in the *Rossheim* case, *supra,* the Board, at page 867, specifically pointed out that option contracts must be supported by consideration.

The controlling factor is not that Lockhart was not required to exercise his option, but that Blair & Co., Inc. had given him more than an offer looking forward to acceptance — they had given him an irrevocable offer; they were bound by a contract. Their original offer became irrevocable when he came with the company early in 1925. By reason of his continued employment and services to the company he was subsequently given irrevocable options until on December 30, 1925 he was given a final irrevocable option to acquire on that date 6,400 shares of stock at a figure $835,337.73 below the market price. This fact is clearly set forth in the Stipulation Par. (6) (16) (R. 54, 57). The fact that he could refuse to exercise the option is quite immaterial. An officer of a corporation can refuse to draw his salary but he cannot by such means postpone payment of income tax.

The facts as stipulated clearly show that Lockhart was not bound to serve the company for any specific period of time. For this reason, as has been already pointed out, the company gave him new options with more advantageous terms to make certain Lockhart would continue with the company. In reality a new

employment contract was created each time Lockhart received a more valuable option and continued in the service of the company. Petitioner has heretofore pointed out that even assuming the original option had no value, it is obvious that the final modified option which was assigned to the petitioner did have a distinct value.

Had these modifications and changes which gave rise to value extended over a period of years it might have been necessary to value each modified option, but since they all occurred in one year the fair market value of the right to acquire said stock under the final option on December 30, 1925 — $835,337.73 — represents the total gain to Lockhart in 1925. It is clear from the record (R. 54, 57) that the last modified option which was tendered Lockhart on December 30, 1925 and which was exercised on December 31, 1925, had a value of $835,337.73, the difference between the book value of $1,452,800.00 on that date and the price of $617,462.27 to be paid by Lockhart.

In the present case the total value of the modified options is to be determined not in 1924, when the first tender was made, nor early in 1925, when the first option terminated. On the contrary the total value of the option agreements to Lockhart is reflected by the value of the final modified option which reflected the income to Lockhart in 1925 by reason of said employment agreement. In this connection it should be remembered that among the reasons for the favorable modification of the option was the continued employment of Lockhart, whose activities in 1925 were bringing to Blair & Co., Inc., earnings which were the principal factors in the increased value of the stock. The modifications in the option were therefore simply a

recognition that additional compensation was due for said services.

If it be kept in mind that at various times in 1925 Lockhart was in fact receiving something of value from Blair & Co., Inc., for his services in the form of increasingly valuable modified option agreements, it will become apparent that respondent's argument throughout these proceedings, relied upon by the Board, with reference to appreciation in property *owned* by a taxpayer or appreciation of options after date of tender, has no bearing on the present case and simply confused the real issue before the Board.

Respondent in his argument before the Board placed great stress on the Board's decision in the case of *D. C. Bothwell,* 27 B. T. A. 1351, 77 F. (2d) 35 and contended that it governs the present case. The Board cited the same case (R. 18) in support of its decision. Analysis of the *Bothwell* case will show that it differs from the present case in many material respects and is clearly distinguishable on the basis of vital facts overlooked by the Board.

In the *Bothwell* case, J. F. Darby desired to purchase stock in a corporation because he wished to share in the benfits of any success the corporation might achieve under his management. The contract was entered into on June 28, 1922, and gave him the right to acquire at any time prior to June 30, 1927, 181,000 shares of stock in the company at $2.56 per share which was apparently not less than the fair market price in June, 1922. In 1926 the option was modified to permit Darby to acquire the stock at $2.00 per share until June 30, 1929, since the corporation recognized the option price was in excess of the value of the stock in 1922. In December, 1927, Darby ex-

ercised his option and in 1928 sold the stock at a profit.

Darby's primary contention before the Board was that he had held the stock since 1922 and the capital gain rate was applicable. In the alternative he contended that his cost was the fair market value in December, 1927, when the option was exercised. The Board denied both contentions.

The vital distinguishing feature between the present case and the Bothwell case is that when Darby received the original option or the modified option and had the right to exercise them they apparently had no value and accordingly could not and were not intended to constitute compensation for services. The record in that case does not indicate that the petitioner made any attempt to prove that either the original or amended options had any value and it is reasonable to conclude that Darby's option never had any value until December, 1927. Lockhart's modified options clearly had a value during 1925 when received by him. This is established by the record and thus they were income to him on the dates received. Said income was all realized in 1925 and constitutes under the law additional cost of the stock acquired by petitioner on the exercise of the option in December, 1925. (See Section 204 (a) (8), Revenue Act of 1926, Appendix, *infra,* p. 39.)

The Board's memorandum opinion attempts to justify the conclusion that Lockhart realized no taxable income under the options by stating (page 14):

> "However, he did not exercise his option, thus he committed no act upon which a tax might be predicated, but instead he chose to transfer his option to the petitioner in a non-taxable exchange under the statute, hence no new basis was estab-

> lished by him either during the ownership of the option by him or because of his transfer thereof to the corporation."

The Board's opinion thus erroneously assumes that because the option was transferred to petitioner, Lockhart escaped the taxable income which would have resulted to him, had he made no transfer and personally exercised the option. The Board's opinion concedes that if Lockhart had personally exercised the option, he would have realized income and the basis on subsequent disposition of the stock would have been the fair market value of the stock at the time the option was exercised. This is unequivocally stated on page 14 of the opinion as follows (R. 19):

> "* * * If Lockhart had exercised his original right and had received his stock, thus actually determining his immediate benefit thereunder, adopting the same reasoning of the *Erskine* case, he would have been taxable upon the difference between $158 and the fair market value of the stock at the time he might have exercised his option. If he had disposed of his stock his new basis for the determination of his gain or loss upon such sale would have been the fair market value of the stock at the time of the exercise."

In other words, the Board's opinion would lead one to believe that Lockhart could escape taxation on the income resulting from the right to exercise the option by *merely* transferring it to petitioner in a non-taxable exchange and then permitting petitioner to exercise the option. This strange result is squarely contrary to the decision in the *Erskine* case. There Erskine assigned the right to acquire certain shares of stock to his wife, but the Board properly held that this

did not relieve Erskine from tax liability because he had, for purposes of taxation, received the income.

The Board's statement in the memorandum opinion (R. 17) referring to the *Erskine* case that "The petitioner there, did not, as Lockhart did, assign his option to a corporation to be exercised by it. He exercised his option and received the shares thereunder according to the terms of the agreement entered into," is squarely contrary to the facts since it is clearly shown that for certain years Erskine's wife was assigned the option and actually exercised it. For example, on page 153 of 26 B. T. A. in the Board's Findings of Fact in the *Erskine* case, it is stated:

> "On November 1, 1923, the petitioner made a similar assignment to his wife of his rights to acquire the preferred stock only, based on the corporation's earnings for 1923, which she exercised in February 1924, paying to Goldman, Sachs, & Company $62,500, and receiving 2500 shares of the preferred stock."

In spite of this assignment, the Board properly held (p. 164):

> "If we are correct in our conclusion that the value of the rights measured by the excess value of the shares of stock acquired by the petitioner or his assignee in each year under the agreement represented compensation for services, then, under the rule of the *Earl* case, (Lucas v. Earl, 281 U. S. 111), we think that such compensation must be taxed to the petitioner as his own income, regardless of the assignments to his wife."

Erskine, in the aforementioned instances, "committed no act upon which a tax might be predicated" other than assigning the option to his wife. Never-

theless, the Board correctly taxed the income to him. The act of exercising the right is apparently quite immaterial and if it were material, it is clear that the exercise by the transferee in a non-taxable transfer, would be sufficient to constitute an exercise of the right by the transferor.

The fact that in the *Erskine* case the rights were transferred to petitioner's wife in a non-taxable transaction whereas here the rights were transferred to a wholly owned company does not alter the situation. For example, in the case of A. D. Saenger, 28 B. T. A. 377, aff'd 69 F. (2d) 631, the petitioner owned 50% of the stock in a corporation and transferred certain property which he was entitled to receive as compensation for services, to the corporation. The Board and the Circuit Court nevertheless, held the value of the property was income to the petitioner.

The mere failure of Lockhart to exercise the option in person does not prevent the valuable rights given by the original option and the amended options from being taxable to him.

This Court has repeatedly recognized the well-established principle that payment to the taxpayer's assignee does not relieve the taxpayer from liability for tax. *Hall* v. *Commissioner*, 68 F. (2d) 399; *Lansill* v. *Burnett*, 58 F. (2d) 512; *Luce* v. *Burnet*, 55 F. (2d) 751.

In *Luce* v. *Burnet, supra,* this Court held that an attorney's entire income for services was taxable to him notwithstanding that through a trust agreement one-half of his income was assigned to his wife. At page 751 the Court said:

> "* * * The case is ruled by the decision of the Supreme Court in *Lucas v. Earl,* 281 U. S. 111,

50 S. Ct. 241, 74 L. Ed. 731, where it was held that the words 'income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid,' include the income of a husband by way of salary and attorney's fees, and that such income is taxable to him, notwithstanding that by a contract between him and his wife all their several earnings, including salaries and fees, are to be received, held, and owned by both as joint tenants. The court said: 'A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that taking the question more technically the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because however the matter might stand between husband and wife *he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone.* But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. *There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.* That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.'

"The fees earned by appellant in the practice of his profession are compensation for personal services and taxable to him. 'However the matter

> might stand between husband and wife,' he could not escape the tax by an anticipatory contract 'devised to prevent the salary when paid from vesting even for a second in the man who earned it'." (Italics supplied)

This decision and that of the Supreme Court in *Lucas* v. *Earl, supra,* clearly indicate that Lockhart could not assign his valuable option which represented income in 1925 from services rendered and by such an arrangement escape income taxes. If "exercise of the right" is a prerequisite, the exercise by the petitioner of the right assigned to it is sufficient to result in taxable income to Lockhart.

But petitioner does not admit that it was necessary to exercise the options in order to have income result to Lockhart. The mere right to purchase stock, which right had a value in excess of $800,000 and which was given to Lockhart as compensation for services in the year 1925 can not be arbitrarily eliminated from his income by a mere failure to exercise it. It is established law that the mere failure of a bondholder to clip his coupons and cash them, does not eliminate the income arising therefrom. Furthermore, the mere failure of an employee to cash a check received as compensation for services does not preclude the Government from contending that the employee received income. Had Blair & Co., Inc. given Lockhart stock worth $800,000 as compensation for services and he had instructed them to turn the stock over to petitioner, could it be argued that he failed to receive income equivalent to the fair market value of the stock. Obviously not, and yet the Board's memorandum opinion reaches the conclusion that although Lockhart received a right worth over $800,000 for stock he failed to receive income.

This conclusion is squarely contrary to the decision of the Supreme Court of the United States in the case of *Corliss v. Bowers,* 281 U. S. 376, 378, where the Court said:

> "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."

The right to subscribe to the stock at a lower figure than its value is the valuable right which is taxable income to Lockhart and under the rule just cited, this income is taxable to him whether or not he sees fit to enjoy it.

Regulations 69, Article 31 promulgated under the Revenue Act of 1926 provide that where property (such as options) is sold by an employer to an employee for less than its market value such employee shall include in gross income the difference between the amount paid for the property and its fair market value. See *Appendix, infra,* p. 40. This, together with Article 33 (Appendix, *infra,* p. 40) clearly indicates an intention to tax income such as that realized by Lockhart.

In the memorandum opinion (R. 18) the Board stated that Lockhart realized no income because "there was no compulsion whatsoever on Lockhart to exercise his option". It is just as persuasive to argue in view of the value of the rights at Lockhart's command, that an employee who is under no compulsion whatsoever to draw his salary realizes no taxable income.

The opinion of the Board in the *Erskine* case is contrary to its conclusion in this case that the option did not represent income until exercised. In that

opinion (pages 162, 163) it held that "the *option itself* at maturity represented compensation for services," because at that time its value had been determined and Erskine was entitled to buy the stock. There were no strings attached to Lockhart's right to exercise his option and at maturity it had a value of more than $800,000 which was compensation to Lockhart for serving Blair & Co., Inc.

In the *Erskine* case the Board stressed the right to subscribe as the determining factor — not the exercise of such right. It specifically stated (page 158) that "It has been recognized that under some conditions rights to purchase shares of stock constitute taxable income", citing *B. F. Saul,* 4 B. T. A. 639, *James F. Shea,* 11 B. T. A. 557 and *Moran* v. *Lucas,* 36 F. (2d) 546.

In *Moran* v. *Lucas, supra,* this Court in holding that rights to purchase stock below market acquired for a consideration represent taxable income stated (p. 548):

> "* * * The appellants contend that the subscription right cannot represent any taxable income until a sale is made of the stock purchased under its terms. It is argued that, until a sale is made, the value of the stock thus secured cannot be definitely ascertained, nor determination made of the loss or profit resulting therefrom. We think, however, that the question is one of present value, and the price realized on actual sales made in the usual and customary manner is admissible to fix such value."

After referring to the above decision of this Court and to *B. F. Saul* and *James F. Shea, supra,* the Board said in the *Erskine* decision (p. 160):

"We can see no difference in principle between those cases and the instant case. There, the *rights to subscribe,* for the shares of stock at less than value were received in consideration for the sale of other stock. Here, the *rights to subscribe* for the stock at less than value were received in consideration for services performed. *The question of the taxability of the rights to receive the shares of stock* is substantially the same." (Italics ours)

It must be evident to this Court that the Board's opinion in this proceeding has ignored the provisions of Section 213 (a), Revenue Act of 1926, and Reg. 69 Art. 31, Art. 33, applicable to the year 1927 here involved. (See Appendix *infra* pages 40, 41)

The Board, various Circuit Courts of Appeals, and the Supreme Court of the United States have all given Section 213 (a) a broad and far-reaching construction. Such was the effect of the Supreme Court decision in *Corliss* v. *Bowers,* cited on page 27 hereof. The Court and Board reports contain many cases in addition to those already cited in this brief, involving stock acquisition contracts between corporations and employees similar to that before the Court in this case.[1] In those decisions the Board and Circuit Courts of Appeals all cited and referred to Section 213 (a) of the 1926 and earlier Acts as warranting the conclusion that the value of the stock received under such arrangements, constituted taxable income to the recipient employee

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[1] *I. C. Bradbury* v. *Commissioner,* 23 B. T. A. 1352, 1360;
Lyle H. Olson v. *Commissioner,* 24 B. T. A. 702, 709; 67 F. (2d) 726; cert. den. 292 U. S. 637;
Commercial Investment Trust Co. v. *Commissioner,* 28 B. T. A. 143; 74 F. (2d) 1015; affirmed per curiam;
Schneider v. *Duffy,* 43 F. (2d) 642, 647, 648;
The Alger-Sullivan Lumber Co. v. *Commissioner,* 57 F. (2d) 3, 4, 5;
Bass v. *Hawley,* 62 F. (2d) 721, 722, *et seq.;*
Hudson Motor Car Co. v. *United States,* 3 F. Supp. 834, 846, 847.

or officer. The opinion of the Board in this proceeding is contrary to said specific provision of the law.

Petitioner accordingly submits that this Court should find that on the evidence before it, Lockhart realized taxable income in 1925 under the original and amended options; that the amount of such income, which was compensation for services, was the difference between the fair market value of the stock covered by the final option ($1,452,800) and the price to be paid under such option ($617,462.27); that Lockhart's cost or basis in the event he subsequently disposed of the option would be the fair market value thereof or $835,337.73; and that petitioner is accordingly entitled to Lockhart's cost of $835,337.73 plus $617,462.27 which it paid for the stock or a total cost of $1,452,800.

III.

The Board's Opinion Erred in Ignoring the Stipulation of Facts.

In the concluding paragraph of its memorandum opinion, the Board states (R. 20):

> "We find ourselves unable to comply with the stipulation of the parties that the items of $223,-602 and $14,581.33 should be included in the 'cost' to Lockhart, if the parties used the word 'cost' as the equivalent of basis since it is in conflict with paragraph (15) of the stipulation, the effect thereof is largely a conclusion of law, depriving the Board of its prerogative to determine for itself, upon the facts, whether such items are properly includable in the basis under the statute, and, furthermore, it appears from a consideration of the actual facts as stipulated that to include such items in the basis we have established, would result in an erroneous determination."

Paragraph (10) of the Stipulation (R. 55, 56) states that the item of $223,602.00 appearing as a credit in reduction of the acquisition price of 6,400 shares of Blair & Co., Inc. stock represents the value of a dividend paid in preferred stock in 1925 by Blair & Co., Inc. on its common stock. The credit was made in favor of Lockhart, who at that time had the right to acquire the common stock of Blair & Co., Inc., and the sum was used in reduction of the final payment due. Paragraph (10) (R. 55, 56) then specifically states

> "Said sum of $223,602 represents an amount to be included in the cost to Henry Lockhart, Jr. —the transferor to petitioner—of the aforementioned option or right."

As the owner of the right to acquire the aforementioned stock of Blair & Co., Inc., Lockhart was entitled to the proceeds of 100 shares of said stock which were disposed of for $14,581.33. Paragraph (11) (R. 56) of the stipulation specifically states

> "Said sum of $14,581.33 was applied by Blair & Co., Inc., in reduction of the price to be paid by petitioner for the acquisition of the aforementioned common capital stock of Blair & Co., Inc. and is to be included in the cost to Henry Lockhart, Jr. of said option or right to acquire common capital stock of Blair & Co., Inc."

The Board's opinion has ignored these stipulated *facts* on the theory that they are in conflict with paragraph (15) (R. 56, 57) of the stipulation and that they are largely conclusions of law. Petitioner submits that the Board's determination is clearly erroneous.

In the first place, Paragraph (15) of the Stipulation

(R. 56, 57) makes no reference to Lockhart's cost and simply provides that certain steps should be followed if the Board holds that *petitioner's* cost of $617,462.27 is to be increased by the items of $223,602.00 and $14,581.33. Whether petitioner's cost is to be increased by these items is a question of law, but Lockhart's cost of the option or right is a plain and simple question of fact. *This is true because the parties had already stipulated that Lockhart received these credits in consideration of his entering and continuing in the employ of the company* (R. 52, 53).

Lockhart clearly rendered services and gave Blair & Co., Inc. valuable consideration for the original option, the amended options and the benefits accruing thereunder. What he was paid for these services is a question of fact. The parties have stipulated that during the year 1925 Lockhart received credit for two items, namely $223,602.00 and $14,581.33 on the purchase price of stock under these options. These credits were valuable property rights and increased the value of Lockhart's option or right by $238,183.33. These property rights were applied on the option purchase price and were in fact "cost" of said option or right to acquire the common capital stock of Blair & Co., Inc.

The Board, itself, in numerous cases has recognized that cost figures may be stipulated. In *E. V. Securities Corp.*, 28 B. T. A. 914, the Board recognized that the cost of stock rights, although difficult of determination, is a conclusion of fact and may be stipulated in a proceeding before the Board:

> "In computing the cost of the stock rights sold by the petitioner in 1928, the values of the stock and rights on December 20, 1925, and November

> 12, 1928, and the percentages of cost applicable to the said stock and rights on those dates, as shown by the deficiency letter, are stipulated to be correct." (p. 915)

In 21 Columbia Law Review, at page 419, a conclusion of law is defined:

> "A conclusion of law is a generic statement which can be made only after some legal rule has been applied to some specific group of operative facts."

At page 25 of 23 Yale Law Journal, Prof. Hohfeld of Yale states:

> "An ultimate fact is a conclusion drawn from intermediate and evidentiary facts."

This Court is thoroughly familiar with the distinctions drawn in these definitions, and it is petitioner's contention that on the basis of these distinctions Lockhart's cost—what he gave up in return for the options or rights, is a conclusion of fact; it is not a conclusion of law because its determination is not fraught with the necessity of applying a legal rule to the operative facts. *It is submitted that if the Board member had not improperly ignored the stipulation of the parties that Lockhart entered into an employment contract, which is indubitably a fact question, he would have been precluded from asserting in his memorandum opinion that Lockhart's cost is a question of law.* The parties to the stipulation specifically recognized this distinction in refraining from stating that the aforementioned items were to be included in petitioner's cost, since this would have required a determination and conclusion that under the law petitioner's cost is

to be based on Lockhart's cost. That is a conclusion of law to be decided by the Board or the Courts.

In this connection petitioner desires to call the Court's attention to the recent decision of the Supreme Court of the United States in the case of *General Utilities and Operating Company v. Helvering,* decided December 9, 1935, 296 U. S. 200. In that case, the Circuit Court of Appeals attempted to find a fact contrary to the stipulated facts and the Supreme Court said (pages 206, 207):

> "* * * Always a taxpayer is entitled to know with fair certainty the basis of the claim against him. Stipulations concerning facts and any other evidence properly are accommodated to issues adequately raised."
>
> * * * * * * * * *
>
> "Also it made an inference of fact directly in conflict with the stipulation of the parties and the findings of the Board, for which the record affords no support whatever. To remand the case for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause."

Similarly in this case, the Board, in failing to adopt the facts stipulated by the parties as to the nature of the agreement between Lockhart and Blair & Co., Inc. and the items to be included in Lockhart's cost, made an inference of fact in conflict with the stipulation of the parties.

Petitioner respectfully submits that the stipulation of the parties did not deprive the Board of its prerogative to determine whether the items in question are properly includable in petitioner's basis under the statute. The Board did, however, err in disregarding

the stipulated facts on the purely *fact question* of "cost" to Lockhart.

The conclusion reached by the Board that the inclusion of such items in the basis to petitioner would result in an erroneous determination is contrary to law. (See Sec. 204(a)(8) Appendix, *infra* p. 39.) On the contrary, the failure to include said item of $223,602.00 (and also that of $14,581.33) in Lockhart's cost, and therefore also in the cost to petitioner, does result in an erroneous determination in that it ignores certain well established principles of law.

IV.

Dividends in Preferred Stock Were Income to Lockhart.

Paragraphs (9) and (10) (R. 54, 55, 56) of the Stipulation, show that the sum of $223,602.00 represents the value of a dividend in preferred stock on the common stock which Lockhart was entitled to purchase. There can be no doubt in view of the decision of the Supreme Court in *Koshland v. Helvering,* 298 U. S. ——, 80 L. Ed. 845 (1936) affirming the principle of *Commissioner v. Tillotson Mfg. Co.,* 76 F. (2d) 189 (1935), that the preferred stock dividend represented taxable income and not a mere dilution of the common stock to which Lockhart was entitled.

In the *Koshland* and *Tillotson* cases the Supreme Court and the Circuit Court held that a dividend in a class of stock other than that held, would represent taxable income for the reason that there was a difference in the character of the stock received. Mr. Justice Roberts speaking for the Court in the *Koshland* case unequivocally stated (L. Ed. p. 847):

> "* * * Where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income."

The preferred stock having a value of $223,602.00 gave Lockhart new rights and interests that did not exist with respect to the common stock. Lockhart, accordingly, in effect received credit for a taxable dividend of $223,602.00 which was applied on the option price of the stock. This item was income to him in 1925 and as such became a capital item reflected in the cost of the option.

Under the rule of the *Rossheim* case, *supra,* the fact that Lockhart did not acquire nominal title to the stock is unimportant. There the Board squarely rejected the premise of the dissent that because petitioner was not given shares of stock by the option contract, the actual purchase price of the stock should be used as a basis for computing his gain. Under the rule of that case, it was not necessary that Lockhart have title to the shares before the Board could find that the credits of $223,602.00 and $14,581.33 represented income received by him in 1925. It is interesting to note that the Board held in the *Rossheim* case (p. 867) that because the taxpayer exercised his option in the same year in which it was granted *it was unnecessary* to consider the question of the value of the right.

The 60 day letter of June 1, 1931, (R. 5), to petitioner did not hold that Mr. Lockhart had no cost for said option. It merely stated—thus framing the issue for the Board—that:

> "Since the cost of the option to Mr. Lockhart, Jr. has not been established, no value is allowable in arriving at the profit from the sale of the stock." (R. 7)

Thereafter, the parties in this appeal submitted "Stipulation of Facts" and in paragraphs (10) and (11) thereof (R. 55, 56) it was specifically agreed that the items of $223,602.00 and $14,581.33 were "to be included in the cost of Henry Lockhart, Jr.",—the transferor to petitioner. Clearly the determination of the respondent that petitioner failed to establish the cost of the option to Henry Lockhart, Jr. was to that extent met by said stipulation of the parties, entered into in good faith. It is submitted that such was a fact question "accommodated",—within the spirit of the Supreme Court decision in *General Utilities Operating Co., supra,*—to the issue raised by the 60 day letter. It is respectfully submitted that this Court should find in the terms of the *General Utilities* decision, that the Board "has made an inference of fact directly in conflict with the stipulation of the parties." This stipulation of fact showed the determination of the Commissioner was wrong and required reversal thereof by the Board and a corrected tax determination. *Helvering* v. *Taylor,* 293 U. S. 507, 515.

CONCLUSION.

It is respectfully submitted that this Court should and will hold that:

(1) The rights to purchase Blair & Co., Inc. stock at less than market value received under option by petitioner's transferor, Henry Lockhart, Jr., constituted compensation for his services.

(2) Said rights so acquired represented taxable income to Lockhart in 1925.

(3) The income realized by Lockhart under the contract of employment was the difference between the fair market value of the stock covered by the option

and the price to be paid therefor by the terms of the option.

(4) The cost of the said Blair & Co., Inc. stock to petitioner was the cash paid by petitioner therefor plus the cost of said option to Lockhart, transferor thereof to the petitioner.

It is, therefore, prayed that this Court reverse the decisions of the United States Board of Tax Appeals with directions to the Board to find (1) that the proper basis for determining gain or loss on the 1927 sale of said 3948 shares of common and 512 shares of preferred stock was a proportionate part of $1,452,800.00, representing (a) $835,337.73 the value and cost to Lockhart of his option on December 30, 1925, plus (b) the $617,462.27 cash paid by petitioner for said 6400 shares of common capital stock, or, in the alternative, (2) that petitioner's cash payment for the aforesaid 6400 shares of common capital stock of Blair & Co., Inc. should be increased by $223,602.00 and $14,581.33, the amounts applied by Blair & Co., Inc. in reduction of the price paid by petitioner in the acquisition of the aforementioned shares of stock; and with direction to the Board to redetermine petitioner's taxes accordingly.

Respectfully submitted,

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APPENDIX.

The applicable statutes are Sec. 203 (a)(b)(4), Revenue Act of 1926, C. 27, 44 Stat. 12; Sec. 204 (a)(8), Revenue Act of 1926, C. 27, 44 Stat. 15; and Sec. 213 (a) Revenue Act of 1926, C. 27, 44 Stat. 23, which read as follows:

"Sec. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under Section 202, shall be recognized, except as hereinafter provided in this section.

* * * * * * * * *

"(b)(4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

"Sec. 204(a) The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * * * * * *

"(8) If the property (other than stock or securities in a corporation a party to a reorganization) was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of Section 203 (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the

transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made; * * *

"Sec. 213 (a) The term 'gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period."

Regulations 69, Article 31: (Revenue Act of 1926)

"* * * Where property is sold by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. In computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition." * * *

Regulations 69, Article 33: (Revenue Act of 1926)

"Compensation paid other than in cash.—Where services are paid for with something other

than money, the fair market value of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash." * * *

FOR MR. CHIEF JUSTICE MARTIN

UNITED STATES
COURT OF APPEALS FOR
DISTRICT OF COLUMBIA
FILED NOV 11 1936
Monroe Rich
CL

No. 6764

In the United States Court of Appeals for the District of Columbia

MERHENGOOD CORPORATION (DEL.), PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

ROBERT H. JACKSON,
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MERHENGOOD CORPORATION (DEL.), PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

OPINION BELOW

The only previous opinion in the present case is that of the United States Board of Tax Appeals (R. 10), which is a memorandum opinion and therefore not officially reported.

JURISDICTION

The appeal in this case involves income taxes for the year 1927 in the amount of $23,146.92 and is taken from a decision of the Board of Tax Appeals entered on February 5, 1936 (R. 42, 2). The case is brought to this Court by a petition for re-

view filed on May 2, 1936 (R. 44), pursuant to the Revenue Act of 1926, c. 27, 44 Stat. 9, Sections 1001, 1002, 1003, as amended by the Revenue Act of 1932, c. 209, 47 Stat. 169, Section 1101, and by the Revenue Act of 1934, c. 277, 48 Stat. 680, Section 519.

QUESTION PRESENTED

After a corporation offered an individual an option on some of its stock as an inducement to enter its employ, the individual assigned the option to the taxpayer, a newly organized corporation, in exchange for all of its capital stock. The taxpayer purchased the option stock for a certain sum and later sold some of the stock. The question presented is whether the correct cost basis of the stock sold by the taxpayer is the amount it actually paid for the stock under Section 204 (a) (8) of the Revenue Act of 1926. This depends upon whether the option acquired by the taxpayer had any cost basis in the hands of the taxpayer's transferor under the circumstances of this case.

STATUTE INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9:

> SEC. 203. (a) Upon the sale or exchange of property, the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.
>
> (b) (4) No gain or loss shall be recognized if property is transferred to a corporation

by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons, this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

SEC. 204. (a) The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * *

(8) If the property (other than stock or securities in a corporation a party to a reorganization) was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of section 203 (including also cases where part of the consideration for the transfer of such property to the corporation was property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made; * * *.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 10–16) and as stipulated by the parties may be summarized as follows:

Prior to December 31, 1924, Henry Lockhart, Jr., was interested in the investment banking field and had successfully organized, financed, and developed several corporations. Blair & Company, Incorporated, offered Lockhart an official position with the company and as an inducement offered him the right to acquire 5,000 shares of its common stock at its asset value on December 31, 1924, which was about $158 a share. The arrangement did not obligate Lockhart to purchase the stock, but simply gave him the right to do so upon that basis. Lockhart accepted the terms of Blair & Company, Incorporated, and became an officer and director thereof in 1925. He was unable immediately to pay for the 5,000 shares of stock, and Blair & Company, Incorporated, extended the right from time to time to acquire the stock on the basis of its book value as of December 31, 1924. The right was finally fixed on December 30, 1925, at 6,400 shares. The increase of the number of shares from 5,000 to 6,400 was due to stock dividends and other stock adjustments (R. 11).

Lockhart organized and incorporated Merhengood Corporation, the taxpayer, under the laws of Delaware on December 30, 1925, for the purpose of acquiring the 6,400 shares of common stock of

Blair & Company, Incorporated (R. 10). On the same day Lockhart transferred his option to purchase 6,400 shares of common stock of Blair & Company, Incorporated, in exchange for 3,000 shares of the taxpayer's stock, representing all the stock outstanding at that time. Under the terms of the option, the taxpayer acquired on December 31, 1925, 6,400 shares of Blair & Company, Incorporated, stock for a cash payment of $617,462.27 (R. 11–12).

The book value of the stock on December 31, 1924, was $158.778 a share (R. 12). On December 31, 1925, the Blair & Company stock had a book value of $227 a share. The stock was not actively traded in but it was the custom for it to be sold and traded in at its book value (R. 11).

Blair & Company, Incorporated, paid Lockhart a salary of $25,000 per year in the years 1925 and 1926 and $35,000 per year in the years 1927 to 1930, both inclusive. In addition to the salaries he was paid a commission in 1928 of $16,634.82. His employment arrangement with Blair & Company, Incorporated, was for an indefinite duration and he left the employ of that company about December 31, 1930. The arrangement under which he was employed did not apply in the case of other employees (R. 11).

In 1927 the taxpayer sold 3,948 shares of common and 512 shares of preferred stock of Blair & Company, Incorporated, which it had acquired

under the option transferred to it by Lockhart, as the result of which the Commissioner determined that the taxpayer derived a profit of $209,422.25, by using a cost basis of $617,462.27 for the 6,400 shares (R. 16). The Board of Tax Appeals determined that the Commissioner had correctly determined the cost basis of the stock in question and sustained the Commissioner's determination.

SUMMARY OF ARGUMENT

In this case, a firm of bankers employed an individual at a certain salary and offered him an option to subscribe to a certain amount of its stock. It does not appear that the option price was less than the market value, but rather that the option price was the same as the market value. The individual did not exercise the option himself, but assigned it to a corporation, the taxpayer, in exchange for all of its capital stock. Then the taxpayer acquired the stock for a certain sum and afterwards sold some of it. The single question in this case is whether the correct basis for that stock is the amount which the taxpayer paid for it. It is the correct basis under the statute unless the option had a cost basis in the hands of the individual, the taxpayer's transferor. The evidence in this case does not establish that the option had any cost basis to the taxpayer's transferor.

ARGUMENT

Where the taxpayer, a corporation, acquired an option in exchange for all of its capital stock to purchase stock of another corporation under the circumstances of this case and then purchases the stock for a specified amount of cash, the cost basis of the stock is the amount the taxpayer actually paid for it within the meaning of Section 204 (a) (8) of the Revenue Act of 1926

While the facts in this case are somewhat complicated, the ultimate question involved is a simple question of fact, namely, the determination of the market value of the option to buy certain stock of Blair & Company, Incorporated, as of December 31, 1924, at which time the taxpayer's transferor acquired it (B. 32). If, as the Commissioner has determined, the option had no market value when it was acquired by the taxpayer's transferor, the cost basis of the stock sold by the taxpayer during the taxable year is what the taxpayer actually paid for it. If, however, the option had a market value when it was acquired by the taxpayer's transferor, that value should be added to the amount actually paid by the taxpayer for the stock in order to determine its cost basis.

It appears that prior to December 31, 1924, Henry Lockhart, Jr., had been successful in the investment banking field. Blair & Company, Incorporated, offered him as an inducement to enter its employ the right to acquire 5,000 shares of its common stock at its book value on December 31, 1924,

which was about $158 a share. The stock was not actively traded in, but it was the custom for it to be sold and traded in at its book value. The arrangement did not obligate Lockhart to purchase the stock, but simply gave him the right to do so upon that basis (R. 11).

Lockhart accepted the terms of Blair & Company, Incorporated, and became an officer and director of that company early in 1925. He was unable immediately to pay for the 5,000 shares of stock and the option was extended from time to time and was finally fixed on December 30, 1925, at 6,400 shares. The increase in the number of shares from 5,000 to 6,400 was due to stock dividends and other stock adjustments (R. 11).

Blair & Company, Incorporated, paid Lockhart a salary of $25,000 a year in the years 1925 and 1926 and $35,000 a year in the years 1927 to 1930, both inclusive. In addition to these salaries he was paid a commission in 1928 of $16,634.82. His employment arrangement with Blair & Company, Incorporated, was for an indefinite period and he left the employ of the company about December 31, 1930. The arrangement under which he was employed did not apply to other employees of the company (R. 11).

Lockhart organized Merhengood Corporation, the taxpayer, on December 30, 1925, for the purpose of acquiring the 6,400 shares of Blair & Company, Incorporated, stock. On the same day the

taxpayer acquired an option from Lockhart to purchase 6,400 shares of common stock in exchange for 3,000 shares of its own common stock which represented all of its outstanding stock on that date. Under the terms of the option the taxpayer on December 31, 1925, acquired the 6,400 shares of Blair & Company stock for a cash payment of $617,462.27 (R. 11–12). The agreement between the taxpayer and Lockhart does not appear in the record.

The book value of Blair & Company stock as of December 31, 1924, was $158.778 a share. The taxpayer's accounts showed that the cost of 6,400 shares of Blair & Company stock was based upon the book value of $158.778 a share, whereas the book value of the stock on the date of the acquisition by the taxpayer, namely, December 31, 1925, was $227 a share (R. 12). The taxpayer sold some of the stock in 1927, as the result of which the Commissioner determined a profit of $209,422.25, using the cost basis for the 6,400 shares of $617,462.27 (R. 16). The taxpayer contends that the stock was sold for less than its cost basis, or, in the alternative, that the cost basis used by the Commissioner should be increased by two items, namely, $223,602, representing the value of a so-called stock dividend, and $14,581.33, representing value of certain stock rights.

It clearly appears from the above-mentioned recitation of facts that the taxpayer actually made

a cash payment of $617,462.27 for 6,400 shares of Blair & Company stock. Therefore, the only question that remains is the determination of the cost basis of the option to purchase the 6,400 shares of Blair & Company stock. Inasmuch as the taxpayer acquired this option in exchange for the issue of all of its common stock, no gain or loss was recognized to the taxpayer's transferor at the time of the exchange on December 31, 1925. Section 203 (a) of the Revenue Act of 1926, *supra,* p. 2, provides that upon the sale or exchange of property the entire amount of the gain or loss shall be recognized except as thereinafter provided. Subdivision (b) (4) of Section 203, *supra,* p. 2, provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person is in control of the corporation. In the instant case the taxpayer acquired the option in exchange for its common stock, and immediately after the exchange Lockhart, the transferor, owned all of the stock of the taxpayer. Therefore the case comes squarely within the provisions of Section 203 (b) (4), which provides that no gain or loss should be recognized under such circumstances.

Section 204 (a) (8) of the same Revenue Act, *supra,* p. 3, provides that the basis for determining the gain or loss shall be the cost of the prop-

erty, except that if the property was acquired after December 31, 1920, by a corporation by the issuance of its stock in connection with a transaction described in paragraph (4) of subdivision (b) of Section 203, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

Inasmuch as the transaction between the taxpayer and Lockhart comes under Section 203 (b) (4), it follows that the cost basis of the option in the hands of the taxpayer is the same as it would be in the hands of Lockhart within the meaning of Section 204 (a) (8). Therefore, the sole question in this case is what was the cost basis of the option in the hands of Lockhart.

As far as the record shows, the option had no value whatsoever in the hands of Lockhart. The option was offered to him on December 31, 1924, at which time the book value of the stock was $158 a share. There is no evidence in the record to show that the market value of the stock at that time was more than $158 a share. On the contrary, the record shows that the stock was not actively traded in and that it was the custom for it to be sold and traded in at its book value. Under such circumstances, the market value was exactly the same as the book value, so that the option had no value

in the hands of Lockhart. The fact that the option was extended to December 31, 1925, at which time the book value of the Blair & Company stock was $227 a share, would seem to be immaterial. Since Section 204 (a) (8) refers to cost basis, and not to the value of the property at any other time, the time for determining the cost basis of the Blair & Company stock is the date on which Lockhart, the taxpayer's transferor, acquired the option, namely, December 31, 1924. On that date the option had no value, because there is no evidence in the record to show that the option price was less than the market value.

The Board of Tax Appeals decided the case on a different ground, namely, that the taxpayer would have to use the same basis for the *stock* that Lockhart would have used. The Board apparently overlooked the fact that Lockhart never owned the *stock;* he had merely an *option* to acquire a certain number of shares at a certain price, and it was this *option*—not the *stock*—which he transferred to the taxpayer in exchange for all of its capital stock. As the Supreme Court said in *Helvering* v. *San Joaquin Co.,* 297 U. S. 496, 498:

> The option itself was property, and doubtless was valuable. If it had been assignable, and the lessee had sold it at a profit, taxable gain would have resulted from the sale. But the option is admittedly not the same property as the land.

The fact that the Board of Tax Appeals decided the case on a different ground than we are urging does not afford a reason for reversing its decision. *Cf. Langnes* v. *Green,* 282 U. S. 531, 538; *Lewis* v. *Reynolds,* 284 U. S. 281. The taxpayer can not say that he was taken by surprise because the Commissioner took the same position in his deficiency notice, which reads in part (R. 7):

> Since Mr. Henry Lockhart, Jr., received all of the stock in exchange for the option, the value of the option to the corporation in accordance with the above-mentioned section, will be the same as it would be in the hands of Mr. Lockhart, Jr., the transferor.
>
> Since the cost of the option to Mr. Lockhart, Jr., has not been established no value is allowable in arriving at the profit from the sale of the stock.

The taxpayer contends that the option constituted compensation for Lockhart's services (Br. 8–12). Under the statute it is the cost of the option which controls and we have already shown that according to the evidence the option had no value when it was given to Lockhart, because the option price was the same as the market value. If Blair & Company had offered Lockhart the opportunity to subscribe to its stock at less than its market value, and he had in fact purchased the stock at less than its market value the Treasury regulations provide that he would have received income to the extent of the difference between the subscription

price and the market value. Treasury Regulations 69, relating to the Revenue Act of 1926, Article 31. The soundness of the Treasury regulations, however, has been questioned by some of the courts. *Taplin* v. *Commissioner,* 41 F. (2d) 454 (C. C. A. 6th); *Commissioner* v. *Van Vorst,* 59 F. (2d) 677 (C. C. A. 9th); *Rose* v. *Trust Co. of Georgia,* 28 F. (2d) 767 (C. C. A. 5th); *Durkee* v. *Welch,* 49 F. (2d) 339 (S. D. Cal.). Whether these decisions are sound or not does not concern us in the instant case because in the first place Lockhart did not receive an option to buy at less than the market value, and secondly, he did not purchase the stock.

All that the option represented to Lockhart was an opportunity to invest some of his capital in Blair & Company, so that he could share in the earnings (or losses) in addition to receiving his stipulated salary for his services. Whether his investment proved to be profitable does not appear in this record because there is no evidence to show that he sold his stock in the taxpayer and what he received for that stock if and when he did sell it.

The taxpayer contends that inasmuch as the parties stipulated that the two items of $223,602 and $14,581.33 should be added to Lockhart's cost of the option, the Board of Tax Appeals erred in ignoring the stipulation (Br. 30–35). We submit that whether these two items should be added to Lockhart's cost of the option is a question of law and not of fact. The Board is not bound by a stip-

ulation of the parties involving a question of law. See *Swift & Co.* v. *Hocking Valley Ry. Co.,* 243 U. S. 281, 289; *Lewis* v. *Commissioner,* 47 F. (2d) 32 (C. C. A. 3d).

The taxpayer also argues that the dividend in preferred stock was income to Lockhart in 1925 when it was declared and therefore represented a capital item reflected in the cost of the option (Br. 35–36). It is a sufficient answer to this argument to show that Lockhart did not own the stock of Blair & Company, but merely held an option to purchase it. Therefore the dividend could not have constituted income to him. Moreover, if he had owned the 5,000 shares of common stock at the time the dividend was declared, it is not clear under *Koshland* v. *Helvering,* No. 774, October Term, 1935, decided by the Supreme Court on May 18, 1936, and not yet officially reported, that this dividend would have constituted income to Lockhart. If there was no preferred stock outstanding at that time, the dividend might not have changed his preexisting proportionate interest in the corporation within the meaning of the decision of the Supreme Court. In such a case it would constitute a return of capital and not income under the Sixteenth Amendment.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should therefore be affirmed.

Respectfully submitted.

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United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA.

Docket No. 6764.

MERHENGOOD CORPORATION, (DEL.) *Petitioner,*

v.

GUY T. HELVERING,
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of Decision of the United States Board of Tax Appeals.

REPLY BRIEF FOR THE PETITIONER.

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REPLY BRIEF FOR THE PETITIONER.

I.

Respondent's Brief Admits that Lockhart's Cost of Option Transferred to Petitioner is to be Added in Determining Petitioner's Cost of Stock.

The Respondent's brief, with commendable frankness, does not contend that the reasoning in the Board's

opinion was correct (Resp. B. p. 12) although it asks that this Court affirm the opinion. The position taken by the respondent in his brief makes unnecessary much of the argument in the petitioner's principal brief for it clears away the questions raised by the erroneous reasoning of the Board. Petitioner reiterates its belief in the soundness and correctness of the views presented in its original brief. However, this reply brief is submitted with the hope that it will clarify the issue and simplify the work of the Court in disposing of this petition for review.

The respondent in his brief (B. p. 6) says:

> "The single question in this case is whether the correct basis for that stock is the amount which the taxpayer paid for it. It is the correct basis under the statute unless the option had a cost basis in the hands of the individual, the taxpayer's transferor. The evidence in this case does not establish that the option had any cost basis to the taxpayer's transferor."

The respondent (B. p. 7) admits:

> "If, however, the option had a market value when it was acquired by the taxpayer's transferor, that value should be added to the amount actually paid by the taxpayer for the stock in order to determine its cost basis."

This raises and presents for decision the cost to Lockhart,—and the acquisition date,—of the option *transferred* on December 30, 1925, to the petitioner.

Thus the real point at issue is made clear by the respondent—a point which the Board admittedly did not determine although petitioner specifically requested a finding thereon. (See Stip., Para. 3, 6 and 16, R. 53 and 57.)

II.

The Option Transferred to Petitioner Was the Option Acquired by Lockhart on December 30, 1925.

The respondent (B. p. 10) states the only question remaining for determination is the cost basis of the option to purchase 6,400 shares of Blair & Co. Inc. stock. Thereafter brief of respondent proceeds on the assumption that the option acquired December 30, 1925, from Lockhart was the option which gave Lockhart the right to acquire only 5,000 shares of Blair & Co. Inc. stock at $158.00 per share. The respondent then states that said option (for 5,000 shares) had no value whatever in the hands of Lockhart (B. p. 11). The respondent ignores, and disposes of the option acquired by Lockhart on December 30, 1925, (R. p. 53) by saying (B. p. 12):

> "The fact that the option was extended to December 31, (*sic*) 1925, at which time the book value of the Blair & Company stock was $227 a share, would seem to be immaterial."

From this passage it seems that the respondent views the case as though only one option was ever received by Lockhart, and that in early 1925; and that the option held by Lockhart on December 30, 1925, and transferred to petitioner was the same option to which value had accrued during the year. That an option for 5000 shares is not the same as an option for 6400 shares is perfectly clear, and a brief reference to the record will serve to correct the mistaken impression under which respondent labors.

The first option which Lockhart acquired from Blair and Co. Inc. as part of the consideration for his entering the company's employ gave him the right to

purchase 5,000 shares of Blair and Co. Inc. stock at $158.00 a share (R. 52, 53). Lockhart was unable to exercise this option because he was unable to pay for the stock (R. 53). His agreement with the company did not commit him to any definite period of employment and he was free to leave at any time (R. 53). The company, however, wanted to retain Lockhart and it was willing to make new arrangements to suit him; accordingly it changed his right to acquire stock so that he had additional time in which to do so and these changes were made because Lockhart remained in the company's employ. (R. 53) The thing he ultimately received for remaining with the company was an option on December 30, 1925, whereby his rights were finally fixed to embrace the right to acquire stock *then,* and to secure 6400 shares instead of 5000 shares. (R. 53) By this increase in shares he was, in effect, to receive the benefits of stock dividends and other adjustments made during the year (R. 53), which he otherwise would have failed to get because he had not exercised the first option when he received it.

Hence on December 30, 1925, Lockhart received a very different *right* from that he received when he entered the company's employment early in 1925. It was a right to buy stock then, which the first option did not give. And it was a right to acquire 6400 shares instead of 5000. Furthermore, the price per share allowed under the first option was $158.00, but the option of December 30, 1925, made the price only $96.48 a share. (R. 19, 53) Moreover the first option covered stock worth $158.00 a share; but the option of December 30, 1925, covered stock then worth $227.00 a share. (R. 53, 50) The first option was given him because

Lockhart joined the company (R. 52); the final option, because he continued in its employ (R. 53).

Not only were the first and final options different contracts *in fact;* but they were different and separable contracts *in law.* The final agreement was not a part of the first contract; it rescinded, superseded and was substituted for the first option contract.

Petitioner has already pointed out in its principal brief that there is nothing unique or peculiar about irrevocable options. They are contracts and subject to the dictates of contract law. See *Williston* on *Contracts* (1936 Ed.) p. 176; *Anson* on *Contracts* (1930 Ed.), p. 55. At paragraph 859 of his treatise on *Options,* James summarizes the law and points out that, as in the case of modified agreements under contract law, a new option contract comes into being even though the only change from the prior option contract is an extension of time.

> "*The extension of the option time* is in reality a new offer in the sense that unless the agreement for the extension is supported by a new consideration the offer may be withdrawn by the optionor at any time before acceptance. If, however, there is a new consideration to support the agreement for the extension, it is binding on the optionor during the time fixed by the extension in the same manner as the original option where such option is supported by a consideration."

In *Cleaves* v. *Walsh,* 125 Mich. 638 (1901) the Court held that a later agreement which only accelerated the option time, rescinded and superseded the prior option contract.

In the case at bar, the options were granted as compensation for services pursuant to the contract of em-

ployment (R. 53). The respondent seems to recognize and the Record shows that Lockhart gave consideration for these options (Br. 7, R. 52, 53).

However, in the instant case not only was the option time extended but the amount of stock covered was increased, the time and amount of payment changed—in reality, an entirely new contract came into existence. Under these facts, it is well settled that the new option rescinds, supersedes and is substituted for the prior option:

In *Runnion* v. *Morrison,* 71 W. Va. 254, 76 S. E. 457, the plaintiff was given an option by the defendant the terms of which were changed by a subsequent agreement. There was no express agreement to rescind the first option. The plaintiff contended that the later agreement covering the same subject matter was a new contract which rescinded and superseded the first option contract. The Supreme Court of Appeals upheld the plaintiff's contention and at page 257 stated:

> "The second option clearly abrogated the first one; *it was a new proposition changing time of acceptance and terms of payment,* and was wholly independent of the first." (Italics supplied.)

Similarly in the case at bar, the final option by mutual consent of the parties changed the time of acceptance and amount of payment and although, as in the case just cited, there was no express rescission, the final option clearly abrogated the earlier options. Williston in his treatise on *Contracts* at page 3145 makes this clear:

> "A subsequent contract completely covering the same subject matter, and made by the same parties, as an earlier agreement, but containing terms in-

> consistent with the former contract, so that the two cannot stand together, rescinds, substitutes and is substituted for the earlier contract and becomes the only agreement of the parties on the subject."

Again at page 3146 of his treatise Williston points out that the agreement to rescind need not be expressed, that mutual assent to abandon a contract, like mutual assent to form one, may be inferred from the circumstances.

In *United Transp. Co.* v. *N. Y. & Baltimore Transp. Co.*, 180 Fed. 902 (1910), the Court held that an oral agreement entered into subsequent to the original contract fixing a new consideration for services to be rendered, rescinded and superseded the first agreement. *It was contended that the altered terms constituted only a modification of the original contract which was still in force and effect, but the Court denied this* and at page 904 said:

> "*It does not advance matters to speak of this conversation as a modification of an existing contract. A contract once made cannot be modified except by a new meeting of minds, and when such mind meeting occurs a new contract springs into existence.*" (Italics supplied.)

In *Housekeeper Publishing Co.* v. *Swift*, 97 Fed. 290, (C. C. A. 8) plaintiff agreed to sell its property for $50,000 and subsequently entered into an agreement to sell for $25,000. Plaintiff brought suit on the first contract. The Court held for the defendant and at page 294 stated:

> "What was the legal effect of the subsequent contract upon its predecessor? * * * The later contract covers the entire subject-matter of the

earlier one. It is complete in itself. It is inconsistent with the preceding contract. The two cannot stand together * * *. A subsequent contract completely covering the same subject-matter, and made by the same parties, as an earlier agreement, but containing terms inconsistent with the former contract, so that the two cannot stand together, rescinds, supersedes, and is substituted for the earlier contract, and becomes the only agreement of the parties on the subject. Clark, Cont. 612; *Patmore* v. *Colburn,* 1 Cromp., M. & R. 65, 71; *Crisman* v. *Hodges,* 75 Mo. 413, 415; *Renard* v. *Sampson,* 12 N. Y. 561, 568; *Stow* v. *Russell,* 36 Ill. 18, 30; *Harrison* v. *Polar Star Lodge,* 116 Ill. 279, 287, 5 N. E. 543, 546; *Howard* v. *Railroad Co.,* 1 Gill 311, 341; *Paul* v. *Meservey,* 58 Me. 419, 421."

In *McCabe* v. *Utah Construction Co.,* 199 Fed. 976, plaintiff orally changed the terms of its contract with the defendant in order to induce the latter to continue certain construction work. Plaintiff brought suit on the original contract but the Court held for the defendant and at page 978 said:

"The second contract covers, and was intended by the parties to cover, the same legal subject-matter as the first and therefore superseded it. *It is a legal impossibility for two inconsistent contracts, covering the same subject-matter between the same parties, each intending to fix the entire compensation for the same services, to exist at the same time.* * * *" (Italics supplied.)

The final option which Lockhart acquired on December 30, 1925, was then, in view of the foregoing authorities, in *law* as well as *fact* a *new option contract distinct and separable from the first option.* It provided a new time of acceptance, and new terms and amount

of payment; the intention to rescind the prior option and substitute the final option, although not expressed, is evident and implicit. It was this option of December 30, 1925, and not the one acquired early in January, 1925, which Lockhart transferred to the petitioner. *It is the market value of this option which, as the respondent has conceded,* "should be added to the amount actually paid by the taxpayer for the stock in order to determine its cost basis." (Br. 7.)

III.

The Option Acquired by Lockhart and Transferred to the Petitioner Had a Market Value on December 30, 1925, the Date of Acquisition, of $835,337.73.

The 6400 shares of stock covered by the option which was acquired by Lockhart on December 30, 1925, had a market value on that date of $227.00 or $1,452,800.00 (R. 53). The option price for said stock was $617,-462.27, or as the Board found, approximately $96.48 a share (R. 54, 44, 19). It is evident from these figures, and the petitioner and respondent have so stipulated, that the fair market value of the option to acquire the 6400 shares of Blair & Co. Inc. stock was on December 30, 1925, $835,337.73. Paragraph (16) of the Stipulation (R. 57) squarely covers this:

> "(16) If the Board should hold that the right given to Henry Lockhart, Jr, to acquire the common capital stock of Blair & Co. Inc. as previously related herein represented at that time taxable income to him, the fair market value of said right to acquire said stock on December 30, 1925, was $835,337.73."

Petitioner submits that the parties by agreement have thus conclusively established the fair market value

of the option acquired December 30, 1925 to be $835,337.73.

IV.

The Market Value of the Option Acquired by Lockhart on December 30, 1925, Should be Added to the Amount Actually Paid by the Petitioner for the Stock to Determine Its Cost Basis.

The respondent concedes this issue at page 7 of his brief, saying:

> "If, however, the option had a market value when it was acquired by the taxpayer's transferor, that value should be added to the amount actually paid by the taxpayer for the stock in order to determine its cost basis."

The petitioner has shown that the option had a market value of $835,337.73 on December 30, 1925, *the date it was acquired by Lockhart,* the taxpayer's transferor, and thus even the respondent's brief becomes authority for adding the market value of the option—$835,337.73—to the amount actually paid for the stock ($617,462.27) in determining that the 6400 shares of stock had a cost basis of $1,452,800.00. But excluding the respondent's concession, the authority is clear.

The option Lockhart acquired on December 30, 1925, was property. *Helvering* v. *San Joaquin Co.*, 297 U. S. 496, 498. It was property received by him as compensation for services pursuant to an employment contract (R. 53); and its fair market value on the aforesaid acquisition date represented both its cost and income to Lockhart in 1925. Section 213 (a), Regs. 69, Art. 33, Revenue Act of 1926. Because petitioner acquired the option in a non-taxable exchange, (Section 203 (b) (4),

Act of 1926) the cost basis of the option in the hands of the petitioner is the same as it was in the hands of Lockhart. Section 204 (a), (8), Act of 1926. Therefore, the petitioner correctly adds Lockhart's cost—$835,337.73—of the option to the amount ($617,462.27) actually paid by it for the stock, making its cost basis $1,452,800.00 as claimed by petitioner.

CONCLUSION.

It is, therefore, prayed that the Court reverse the decision of the United States Board of Tax Appeals with directions to the Board to find (1) that the option which was exercised by the petitioner in purchasing the 6400 shares of Blair & Co. Inc. stock was acquired by Lockhart on December 30, 1925; (2) that said option had a fair market value of $835,337.73 on December 30, 1925; (3) that this amount, representing income—compensation for services—and the cost of the option to Lockhart, should be added to the amount actually paid by the petitioner for the stock in determining its cost basis; and with direction to the Board to redetermine petitioner's taxes accordingly.

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